No. 88-36 (1)

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

BENEFICIAL CORPORATION, FINN M.W. CASPERSEN,
ANDREW C. HALVORSEN,

Petitioners,

—against—

ROBERT M. DEUTSCHMAN,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTION PRESENTED

Whether the Court of Appeals erred in holding that the purchaser of a call option on a corporation's common stock can sue the corporation and its officers under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder for alleged misstatements, where neither the corporation nor the officers have: (a) traded in the option or the security, (b) consented to the issuance, sale or purchase of the call option, (c) any control over the market for call options, or (d) any relationship to the purchaser of the call option.

PARTIES TO THE PROCEEDING AND RULE 28.1 LIST

The caption of the case in this Court contains the names of all the parties to the proceedings in the court below.

Petitioner Beneficial Corporation has no parent companies or affiliates to list pursuant to Rule 28.1 and all subsidiaries of Beneficial Corporation are either wholly owned or owned in concert with other wholly owned subsidiaries of Beneficial Corporation.

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Petitioners, Beneficial Corporation ("Beneficial") and two of its officers and directors, Finn M.W. Caspersen and Andrew C. Halvorsen, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit entered in this proceeding on March 7, 1988.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 841 F.2d 502, and is reprinted in the appendix hereto at pages 1a - 14a. The order of the Court of Appeals denying a petition for rehearing and rehearing en banc is not reported, and is reprinted in the appendix hereto at page 29a. The opinion of the District Court is reported at 668 F. Supp. 358, and is reprinted in the appendix hereto at pages 15a-26a.

JURISDICTION

The judgment of the Court of Appeals was entered on March 7, 1988. A timely petition for rehearing and rehearing en banc was denied on April 4, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTE AND RULE INVOLVED

The statute and rule involved in this action, which are set forth in full in the appendix at page 30a, are Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b) ("Section 10(b)") and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 ("Rule 10b-5").

STATEMENT OF THE CASE

The decision below has serious ramifications and constitutes an unprecedented expansion of the scope and applicability of the judicially implied private right of action under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. It is therefore essential that this Court step forward, as it has consistently in the past, to address the requirements that a private litigant must

fulfill in order to maintain a claim for damages under that statute and rule. *E.g. Basic Inc. v. Levinson*, ___ U.S. ___, 99 L. Ed. 2d 194 (1988) (materiality); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (manipulation and deception); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (scienter); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (purchaser/seller requirement).

Specifically, this case presents the question whether the purchaser of a call option on Beneficial common stock can sue Beneficial and two of its officers under Section 10(b) and Rule 10b-5 where the *only* allegations are that the defendants made misstatements affecting the price of the option and the underlying common stock. Importantly, none of the defendants issued the call options, sold the call options, or even traded in the call options or Beneficial's common stock. Moreover, defendants had no control over the type or number of call options issued, and no contractual or other relationship with respondent. Indeed, as explained *infra*, the person who sold the call options to respondent need not have owned Beneficial common stock at the time of the sale.

The right of purchasers and sellers of standardized call options (as well as other derivative securities not issued by corporations) to assert a cause of action for damages against corporations under Section 10(b) and Rule 10b-5 is one of critical importance to U.S. corporations and our capital markets. In 1987 more than $110 billion in options and index options based on the common stocks of major corporations were traded in the United States. *See* SEC Monthly Statistical Review, Vol. 47, No. 3 at 10, 11, 13 (March 1988). To permit traders of these derivative securities to pursue fraud claims under circumstances where the company has no relationship to the option or the purchaser thereof would create the precise

evil this Court warned against in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975): "unduly expansive imposition of civil liability" resulting in "'large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers.'" 421 U.S. at 739 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969)).

A. The Allegations of the Complaint.

Respondent Robert M. Deutschman filed the original complaint in this action in the United States District Court for the District of Delaware on December 22, 1986, naming as defendants petitioners Beneficial Corporation, Finn M.W. Caspersen, its chairman of the board of directors and chief executive officer, and Andrew C. Halvorsen, a director and its chief financial officer. On March 5, 1987, respondent filed an amended complaint naming the same parties as defendants (the amended complaint is referred to herein as the "Complaint").

Respondent alleges that he purchased call options on the common stock of Beneficial through the Pacific Coast Stock Exchange on November 25, 1986 and December 12, 1986 and claims to represent a class of persons, other than petitioners and their affiliates, "who purchased the common stock of [Beneficial] or purchased call option contracts thereon, during the period August 21, 1986 through February 27, 1987." Respondent does not allege that he ever purchased, sold or owned shares of common stock of Beneficial or any other security issued by Beneficial.[1]

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1 Respondent's claim to represent persons "who purchased common stock of Beneficial" is meritless; a plaintiff cannot represent a putative class of which he is not a member.

(Footnote continued)

The Complaint sets forth one cause of action under Section 10(b) of the Exchange Act and Rule 10b-5 and a claim for negligent misrepresentation under state law. The Complaint alleges that petitioners Caspersen and Halvorsen are liable as direct participants, aiders and abettors, or "control persons" under Section 20(a) of the Exchange Act.

Respondent sets forth a number of alleged misstatements which he claims appeared in Beneficial's 1985 Annual Report to Shareholders, letters to stockholders dated August 21 and November 14, 1986, various reports filed with the Securities and Exchange Commission and newspaper articles which appeared in *The Wall Street Journal* on September 2 and December 16, 1986. Respondent does *not* allege that he relied upon or even read any of these statements, or that any of these statements were made to prospective purchasers of call options in order to induce them to purchase their options. Respondent avers only that these public statements affected the prices of the call options he purchased and of Beneficial's common stock. Likewise, the Complaint does not allege that Beneficial, Caspersen or Halvorsen, during the time period complained of, traded in Beneficial stock or in options on Beneficial common stock.

(Footnote 1 continued from previous page)
East Texas Motor Freight System, Inc. v. Rodriguez, 431 U.S. 395, 403 (1977); *Sosna v. Iowa*, 419 U.S. 393, 403 (1975); 3B J. Moore, Moore's Federal Practice ¶ 23.04[2] (2d ed. 1987). This, however, is not an issue at this time since what is at stake here is the question of respondent's standing to pursue his federal securities claims regarding the options.

B. The Proceedings Below

On March 20, 1987, petitioners moved the District Court to dismiss the Complaint, pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, on the grounds that: (i) respondent lacked standing to raise the claims set forth in the Complaint, (ii) the Complaint failed to state a claim upon which relief could be granted, and (iii) there was no pendent jurisdiction over plaintiff's claim of negligent misrepresentation. On July 30, 1987, Chief Judge Murray M. Schwartz granted defendants' motion and dismissed the Complaint. *Deutschman v. Beneficial Corp.*, 668 F. Supp. 358 (D. Del. 1987)(App. 15a-26a)[2], *rev'd*, 841 F.2d 502 (3d Cir. 1988). Judge Schwartz held that: (i) respondent had no standing to assert a cause of action under Section 10(b) of the Exchange Act and Rule 10b-5, and (ii) in light of the dismissal of respondent's federal claims, the District Court lacked jurisdiction over the pendent state law claim. 668 F. Supp. at 364 (App. 25a).

On March 7, 1988, the United States Court of Appeals for the Third Circuit reversed Judge Schwartz, finding that the purchaser of a call option has standing to sue the issuer of the common stock underlying the call option under Section 10(b) of the Exchange Act and Rule 10b-5. *Deutschman v. Beneficial Corp.*, 841 F.2d 502 (3d Cir. 1988)(App. 1a-14a). Relying on its earlier decision in *Peil v. Speiser*, 806 F.2d 1154 (3rd Cir. 1986), and common law tort principles, the Third Circuit utilized the so-called "fraud on the market" approach to establish causation. In so doing, however, the court also

2 References to "App. ___" are to the appendix submitted with this petition.

expanded the scope of liability under Section 10(b) and Rule 10b-5 more broadly than any Court of Appeals, giving the purchaser of *any* security standing to sue *anyone* if he can allege only that the putative defendant's misstatements affected the price of a security the plaintiff purchased. The court failed to recognize that the mere fact that a plaintiff claims to be injured by reason of his purchase of a security (*i.e.*, a call option) is not the end of the inquiry but rather the beginning. While the option is, of course, a "security" it is not a security issued by the defendant corporation and hence, under applicable law, respondent must plead some relationship or transactional nexus to the corporation in order to state a cause of action against it under Section 10(b) and Rule 10b-5. The Court of Appeals, however, simply ignored this legal requirement in reversing the District Court.

On April 4, 1988, petitioners' petition for rehearing with suggestion for rehearing en banc was denied (App. 29a).

C. The Unique Characteristics and Risks of Options and Other Derivative Securities.

Respondent bases his claims upon his trading in standardized call options on Beneficial common stock. As with all derivative securities, these options are not the securities of Beneficial. Indeed, Beneficial is not in any way connected to their issuance or sale, nor does Beneficial receive any proceeds or other consideration from the trading of these options.

1. OCC Options

The options in which respondent traded are standardized options created by The Options Clearing Corpo-

ration ("OCC"), not Beneficial.[3] The OCC defines an option on common stock as "a legal contract that gives the holder the right to buy or sell a specified amount of the underlying interest at a fixed or determinable price . . . upon exercise of the option." OCC Booklet at 4. There are two types of equity options: a "call" option, which gives the holder the right to purchase a specified amount of the underlying security at a fixed price during the term of the option, and a "put" option, which conveys the right to sell at a specified price during the term of the option. *Id.* The price at which the underlying security may be bought or sold is referred to as the "strike" price or exercise price.

Call options are short-term, highly speculative instruments. They are wasting assets and must be exercised before their expiration date or they become valueless. *Id.* at 9, 16. Therefore, an option trader must not only guess correctly about the direction of the price of the underlying stock (*i.e.*, whether it will increase or decrease), but also the timing and extent of that increase or decrease in the stock price. *See id.* at 16-17. In return for this risk, however, the call option trader realizes corresponding opportunities for enormous profits.

While these opportunities can be greatly rewarding, purchasers of call options stand to lose their entire in-

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3 *Characteristics and Risks of Standardized Options* 1 (Sept. 1987) (the "OCC Booklet"). This booklet, issued by the OCC, is the "options disclosure document" which must be furnished by a broker or dealer before accepting an order from a customer, pursuant to SEC Rule 9b-1. *See* 17 C.F.R. § 240.9b-1. The OCC also issues a prospectus which pertains to put and call options.

vestment if the underlying stock does not reach the selected strike price prior to expiration. *Id.* at 16. Selling calls is also risky. The writer (seller) of a call option is paid a "premium," which is described as "a nonrefundable payment -- from the option buyer to the option writer -- for the rights conveyed by the option." *Id.* at 6. The writer takes the risk that if the stock price rises to a point above the strike price, and the option is then exercised, he must sell the underlying stock at the lower strike price. *Id.* at 18. This risk is augmented if the option writer decides to sell "uncovered" or "naked" options -- *i.e.*, options on stock that the trader does not own -- since he may have to buy the stock at a much higher market price and then resell it at the agreed-upon strike price. His liability is therefore potentially limitless. *Id.* at 19-20.

Put and call options are issued by the OCC and, unlike common stock, contribute no equity to the corporation. OCC Booklet at 70-71. The issuer of the underlying common stock is not connected in any way with the writing and trading of standardized options. Rather, the OCC matches the aggregate rights and obligations of option buyers and sellers. Thus, the purchaser must rely on a backup system established by OCC and not any particular option writer for performance. Similarly, the obligations of option writers are owed to OCC rather than to any particular buyer. *Id.* at 70.

Unlike its obligations with respect to its own publicly traded securities, Beneficial has no registration, reporting or disclosure responsibility for options issued by OCC. *See, e.g.*, Sections 12, 13 and 14 of the Exchange Act, 15 U.S.C. §§ 78l, 78m, 78n. *Beneficial has no voice or say in the number or type of options issued, and no contractual or other relationship with either the persons who trade options or the OCC.* As the OCC warns traders of

its options: "Issuers of underlying stocks do not participate in the selection of their stocks for options trading . . ., have no responsibility regarding the issuance, the terms, or the performance of the options . . ., and option holders have no rights as security holders of such issuers." *Id.* at 71.

Beneficial, which has an interest in the trading markets for its publicly traded securities and receives benefits from the public market for its securities, receives no equity or other consideration from the issuance and trading of options on those securities. Indeed, options issued by OCC compete with Beneficial for the investor's dollar. *See Bianco v. Texas Instruments, Inc.*, 627 F. Supp. 154, 159 (N.D. Ill. 1985).

2. Other Derivative Securities

While the decision of the Third Circuit is dramatic in its application to put and call options issued by the OCC, it has implications far beyond that market. As this Court is aware, in recent years the securities markets have seen the proliferation of various new kinds of derivative instruments, such as index options, most of which are based on standardized portfolios of stocks and traded on various exchanges.[4] For instance, both the Philadelphia and the American Stock Exchanges have recently proposed trading of certain index based securities referred to as Cash Index Participations and Equity Index Participations, respectively, in which the purchaser does not trade or have an ownership interest in the underly-

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4 For example, the Chicago Board Options Exchange handles options contracts on the Standard & Poors 100. *Report of the Presidential Task Force on Market Mechanisms* 5 (1988).

ing stock, but will, instead, be entitled to cash payments which are equivalent to a proportionate share of regular cash dividends declared on the component stocks of the index. *See* Exchange Act Release No. 25495, 53 Fed. Reg. 10311, 10314 (March 30, 1988); Exchange Act Release No. 25644, 53 Fed. Reg. 16805, 16807 (May 11, 1988). Purchasers will have no rights as security holders in the underlying issuers and, unlike options, there will be no expiration date. The holder will have an opportunity each quarter to "cash-out" his position in addition to receiving a quarterly dividend. 53 Fed. Reg. at 10314, 16807.

These new kinds of instruments bring to the table a whole host of potential new plaintiffs who, under the reasoning of the Third Circuit, are armed with the right to bring damage claims under a statute which never expressly granted any right to sue in the first place. The creation of such liability by judicial implication requires the closest scrutiny by this Court.

REASONS FOR GRANTING THE WRIT

The primary reason this case should be reviewed by this Court is that the Third Circuit decision not only radically and inappropriately expands the scope of liability under Section 10(b) of the Exchange Act and Rule 10b-5, it is in direct conflict with (i) prior decisions of this Court governing the extent to which federal courts may imply a private right of action under the federal securities laws and (ii) a decision of the United States Court of Appeals for the Eighth Circuit, which squarely refused to adopt the rule now embraced by the Third Circuit in this case, as well as decisions of district courts in at least three other circuits. As a result, the decision below has transformed an apparently clear area of the law into one filled

with contradiction and uncertainty, which only this Court can resolve.

I

THE DECISION BELOW CONFLICTS WITH EXISTING LAW

A. The Decision Is In Conflict With Prior Rulings Of This Court.

The issue in this case is not whether the facts alleged in the Complaint would, under appropriate circumstances, form a basis for penal sanctions or an action for injunctive relief by the Securities and Exchange Commission. Instead, this case presents solely the question of whether an option trader, who is a complete stranger to the corporation, should be permitted to sue the corporation for money damages. In answering this question in the affirmative the Third Circuit has implied a cause of action where none exists by ignoring or misapplying the careful criteria established in *Cort v. Ash*, 422 U.S. 66 (1975). The result is a ruling which is in conflict with the prior decisions of this Court and potentially dangerous.

As this Court has repeatedly emphasized "the fact that a federal statute has been violated and some person harmed does not automatically give rise to a private cause of action in favor of that person." *Cannon v. University of Chicago*, 441 U.S. 677, 688 (1979); *accord Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11, 24 (1979); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568 (1979). Instead a court must look carefully at the specific factors enumerated in *Cort v. Ash* to determine whether a cause of action can properly be implied. This is particularly true where, as here, the newly-

created claim may involve critical implications for our courts and our capital markets; unfortunately, the Third Circuit failed to follow this Court's teachings.

The first, and most important factor under *Cort v. Ash* is whether the plaintiff is one of the class for whose "*especial* benefit" the statute was enacted. *Cort v. Ash*, *supra*, at 78; *Cannon v. University of Chicago*, *supra*, at 689-94. Put another way, is the statute sufficiently protective of some special group so as to give rise to a private cause of action by a member of that group?[5] Applied to the Exchange Act, this Court has sanctioned a private right of action only where there is a pervasive legislative scheme governing the relationships at issue between the plaintiff group and the defendant. *Compare Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977) (defeated tender offeror does not have standing to sue for money damages under Section 14(e) of the Exchange Act because that section is intended to protect stockholders of the target) *with J.I. Case & Co. v. Borak*, 377 U.S. 426, 431-33 (1964) (finding a private right of action by stockholders for violation of the proxy rules). Here, there plainly is no such scheme, as well as no such relationship between the plaintiff and defendants.[6]

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5 It is not enough that the statute provides penal sanctions intended to protect some individual, social or public interest (*Cort v. Ash*, 422 U.S. at 79-81) or that the statute might provide a private right of action to other plaintiffs or even the same plaintiff in other circumstances (*Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 37-39 (1977)).

6 There is, of course, a very specific relationship between the corporation and its security holders, as spelled out in the Exchange Act. For example, Sections 12 and 13(a) of the Exchange Act require a corporation to file a registration statement containing specified information if its securities are traded on a national securities exchange and to publish and file period-

(Footnote continued)

Clearly, the purchaser of a call option, who does not purchase either an option from the corporation or an option issued by the corporation, cannot be said to be part of a "pervasive legislative scheme" because in fact there is no such scheme. Similarly where, as here, the option holder alleges only that claimed misstatements affected the price of the call option purchased, it is hard to imagine how plaintiff could assert that he is part of any class for whose "especial benefit" Section 10(b) was designed. And, as this Court noted in *Cannon v. University of Chicago*, there is "far less reason to infer a private remedy in favor of individual persons" where the statute is merely phrased in prohibiting terms, as here, instead of with "an unmistakable focus on the benefited class . . . ." 441 U.S. at 690-91. In short, it is peculiarly inappropriate to imply a cause of action in this case.

(Footnote 6 continued from previous page)
ic reports to holders of such securities. 15 U.S.C. § 78l, 78m(a). Section 14 of the Exchange Act requires a corporation to make certain disclosures to holders of its equity securities where proxies are solicited or other shareholder action is sought or a tender offer for those securities is made. *Id.* § 78n. Similarly, Section 13(d) requires holders of more than five percent of a corporation's equity securities to make certain disclosures to the corporation and other holders of the corporation's securities. *Id.* § 78m(d). These detailed obligations running between a corporation and its security holders stand in stark contrast to the lack of any such obligations between Beneficial and persons who are not holders of the company's securities, such as respondent. None of the registration, reporting and disclosure obligations requires disclosure to holders of options or requires any option holder to make disclosure to the corporation. They are total strangers to each other.

This conclusion is not only mandated by the teaching of *Cort v. Ash*, it is in accord with other decisions of this Court determining the parameters of the right of action under Section 10(b) of the Exchange Act and Rule 10b-5 -- standing to sue must stem from some relationship or transactional nexus between the parties. *See, e.g.*, *Chiarella v. United States*, 445 U.S. 222, 230 (1980) ("liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction"); *Dirks v. SEC*, 463 U.S. 646, 657-58 (1983); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977); *see also SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 860 (2d Cir. 1968) (the connection with a purchase or sale requirement is satisfied, provided that the misstatements are "of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase and sell *a corporation's securities*") (emphasis added), *cert. denied*, 394 U.S. 976 (1969).

The Third Circuit ignored the analytical standard for creating causes of action as well as the settled principles set forth in the Rule 10b-5 cases cited above. Instead, the court created its own two-step approach: first, it invoked the common law tort rule which imposes liability if a defendant violates a statute and causes injury to plaintiff; and second, because there was no allegation that respondent relied on any of the petitioners' alleged misstatements, the court utilized the causation principle embodied in the so-called "fraud on the market" theory to supply the requisite element of reliance or causation. 841 F.2d at 507 (App. 11a-12a). *See Peil v. Speiser, supra*. In so doing the Third Circuit was again clearly in error.

First, tort principles alone can never justify implication of a private right of action. *Touche Ross v. Reding-*

ton, supra, at 568; *see also Cannon v. University of Chicago, supra*, at 688. Second, the court's use of the "fraud on the market" theory to impose liability on corporations in favor of those who trade options on the corporation's securities conflicts with this Court's recent decision in *Basic Inc. v. Levinson*, ___ U.S. ___, 99 L. Ed. 2d 194 (1988).

In *Basic*, this Court held that a purchaser of a *corporation's* securities could sue the company for damages based on alleged misstatements and omissions, so long as the plaintiff alleged reliance on the integrity of the market. ___ U.S. at ___, 99 L. Ed. 2d at 215 (quoting *Peil v. Speiser, supra*, 806 F.2d at 1160-61). But the entire premise of the theory -- that a purchaser is relying on a fair market to reflect a fair price -- is inapplicable here. The very nature of an instrument like a call option -- which requires the purchaser to gamble on the direction that the market will take -- is that the purchaser is relying not on the market's integrity but, rather, on his own belief that the market price of the underlying common stock is *not* reflective of its true value. *See Zlotnick v. TIE Communications*, 836 F.2d 818, 822-23 (3d Cir. 1988). Thus, the fraud on the market theory simply has no legal or logical application here and the Third Circuit's failure to understand that constituted error.

To summarize briefly, the lower court failed to apply the correct standard for implying causes of action and instead created its own ill-founded approach. By so doing, the court rendered a decision which is in direct conflict with the prior rulings of this Court and, as such, should not be allowed to stand.

B. The Opinion Conflicts With A Recent Decision Of The Eighth Circuit And Decisions In Other Federal Courts.

Despite some earlier decisions to the contrary, *e.g.*, *In re Digital Equip. Corp. Sec. Litig.*, 601 F. Supp. 311 (D. Mass. 1984); *Lloyd v. Industrial Bio-Test Laboratories*, 454 F. Supp. 807 (S.D.N.Y. 1978), the clear weight of authority, including a decision by the Court of Appeals for the Eighth Circuit, is that option traders do not have standing to sue the corporation which has issued the underlying common stock for damages under Section 10(b) of the Exchange Act and Rule 10b-5. *E.g.*, *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983); *Data Controls North, Inc. v. Financial Corp. of America*, ___ F. Supp. ___, 1988 U.S. Dist. LEXIS 4602 (D. Md. 1988); *Tolan v. Computervision Corp.*, C.A. No. 85-1396-N (D. Mass. December 8, 1987) (Magistrate's Report and Recommendation); *Starkman v. Warner Communications, Inc.*, 671 F. Supp. 297 (S.D.N.Y. 1987); *Bianco v. Texas Instruments, Inc.*, 627 F. Supp. 154 (N.D. Ill. 1985).

In *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983), the Court of Appeals for the Eighth Circuit reached a result in direct conflict with the decision below. In that case, plaintiff, a purchaser of call options on General Dynamics common stock, alleged that General Dynamics purchased shares of its common stock without disclosing a pending dividend. Finding a lack of fiduciary duty or similar relationship of trust between an issuer of common stock and the holder of options on that stock, the district court dismissed the complaint.

In affirming the district court the Eighth Circuit, citing this Court's decision in *Chiarella v. United States*, 445 U.S. 222 (1980), found that

> plaintiff fail[ed] to demonstrate that [defendant] . . . owed any special duty to the plaintiff who merely held an option to buy [defendant's] stock from a third party. There simply existed no relationship of trust and confidence between the parties. As *Chiarella* makes clear, "liability is premised upon a duty to disclose arising from a relationship of trust and confidence *between parties to a transaction.*"

704 F.2d at 411-12 (citation omitted) (emphasis added by the court); *see also Dirks v. SEC*, 463 U.S. 646, 657-58 (1983) ("We reaffirm today that '[a] duty [to disclose] arises from the relationship between parties'") (quoting *Chiarella* at 231 n.14). The Eighth Circuit observed that while the corporation and its officers and directors assume a fiduciary duty to the buyer of the corporation's stock, the same cannot be said *vis a vis* the purchaser of options. 704 F.2d at 412. "They were still complete strangers and ordinarily no duty would be owed." *Id.* The court observed that the corporation had never entered into any contract with the options trader, had neither issued, sold or purchased options, nor had any control over the issuance or trading in options -- in stark contrast to the corporation's relationship with its own common stock. *Id.* at 411. Further, the court noted that

> "The relationship between corporate insiders and shareholders stands in stark contrast to the lack of relationship between the corporate insiders and options traders. . . . [T]he dispositive distinction is that *the*

> *options trader has no equity interest in the corporation by virtue of his selling or purchasing an option on the corporation's stock. He is owed no special duty by the officers and directors of the corporation because, quite simply, the corporation is not run for his benefit.* He has contributed no equity to the corporation and, in the event of insider wrongdoing, he has no right to bring suit to make the corporation whole."

704 F.2d at 411 (quoting *O'Connor & Assoc's* v. *Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179, 1184-85 (S.D.N.Y. 1981) (emphasis added)). In sum, the court held, "[w]e find there must be some special relationship between plaintiff and defendant before a duty of disclosure arises. Here there is none." 704 F.2d at 413.

The Third Circuit attempted to distinguish *Laventhall* on two bases, neither of which has any merit. First, the court tried to characterize *Laventhall* as an insider trading case in which, under this Court's decision in *Chiarella*, there was no transactional nexus between the alleged nondisclosure and the market for options. 841 F.2d at 507 (App. 10a-11a). In addition, the Third Circuit attempted to forge a meaningful distinction between the nondisclosure alleged to have occurred in *Laventhall* and affirmative misrepresentations. *Id.* (App. 11a). The Third Circuit is plainly wrong on both counts.

First, there is no way to wedge the holding of *Laventhall* into a narrow insider trading niche. In *Laventhall*, the plaintiff's alleged injury stemmed from the fact that General Dynamics failed to disclose to holders of call options a pending dividend on its common stock. Plaintiff then sold his options without knowledge of that pending dividend. If the reasoning of the Third Circuit

were correct, the Eighth Circuit's *Chiarella* analysis in *Laventhall* was superfluous because the simple causal nexus between the alleged nondisclosures and the injury to the sellers of the call options should have been enough to state a cause of action. But the Eighth Circuit's *Chiarella* analysis was not superfluous, and that court correctly reasoned that some transactional nexus or relationship, in addition to mere causation, must be present to impose liability to purchasers or sellers of call options for false and misleading statements under Section 10(b) of the Exchange Act and Rule 10b-5. Since that transactional nexus or relationship is as absent in this case as it was in *Laventhall*, the decisions of the Third and Eighth Circuits simply cannot stand side by side. If the Third Circuit is correct that a corporation is liable for false and misleading statements to a purchaser of any security in any market, then *Laventhall* was incorrectly decided.

The Third Circuit's view that *Laventhall* is also distinguishable because the case dealt with nondisclosures rather than misrepresentations is also wrong. Such a distinction misconstrues the *Laventhall* decision. First, the Eighth Circuit made no such distinction. Second, no such distinction can or properly should be made in these kinds of cases because a misrepresentation of fact is in reality no more than the nondisclosure of the true fact. *See Little v. First California Co.*, 532 F.2d 1302, 1304 n.4 (9th Cir. 1976); *Frankel v. Wyllie & Thornhill, Inc.*, 537 F. Supp. 730, 739 (W.D. Va. 1982); *Sullivan v. Chase Inv. Serv., Inc.*, 79 F.R.D. 246, 262 (N.D. Cal. 1978). In other words, attempting to force the result in these cases by divining whether there was a "nondisclosure" or an affirmative erroneous disclosure is to trivialize the analysis and to enter a legal never-never land. The Eighth Circuit did no such thing.

The standing limitations on purchasers of call options enunciated in *Laventhall* were based on the lack of any relationship between parties, not on whether the defendant allegedly engaged in omissions or misrepresentations. Because option traders "stand in the same structural relationship" or lack thereof to the issuing corporation, whether there was disclosure or nondisclosure, *see In re McDonnell Douglas Corp. Sec. Litig.*, 567 F. Supp. 126, 127 (E.D. Mo. 1983), there can be no standing in either case.[7] Moreover, the Third Circuit's misrepresentation/omission distinction is unworkable as a practical matter. To cite one example, in the Complaint plaintiff alleges both misrepresentation and nondisclosures. Complaint ¶¶ 52, 53. Presumably, according to the Third Circuit, plaintiff would now have standing to sue for the alleged misrepresentations but not for the alleged nondisclosures. This, we submit, makes no sense because, as the Third Circuit recognized in *Peil v. Speiser*, *supra*, omissions can have the same effect on the market price of a security as misrepresentations. 806 F.2d at 1162. By ignoring that fact in this case and creating a new misrepresentation/omission distinction, the Third Circuit has produced a circumstance where the ability to generate massive and expensive litigation would amount to nothing more than a pleading exercise. This, we submit, is senseless.

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7 *See also Bianco v. Texas Instruments, Inc.*, 627 F. Supp. 154, 161 (N.D. Ill. 1985) ("We do not agree that the distinction between affirmative misrepresentation and nondisclosure calls for a different rule as to the standing of options traders to sue under § 10(b). Instead, we read *Chiarella* and its progeny as indicating that there must be some relationship, or some connection between the plaintiff and the § 10(b) defendant.").

In sum, no matter how hard the Third Circuit strained to do so, its decision cannot be reconciled with the holding in *Laventhall*, let alone the spate of lower court decisions which have recognized that option holders do not have standing to sue in these circumstances. Accordingly, it is vital that this Court resolve the conflict and put the matter to rest.

II

STRONG POLICY REASONS REQUIRE THAT OPTION TRADERS BE DENIED STANDING UNDER SECTION 10(b) AND RULE 10b-5

As this Court has observed, even when the factors enumerated in *Cort v. Ash*, *supra*, are satisfied, courts have the further obligation to consider the defendants' "countervailing arguments" of a policy nature which weigh against implication of a private right of action. *See Cannon v. University of Chicago*, 441 U.S. at 689, 709-712. Here, the Third Circuit rejected the strong policy reasons favoring a limitation on the potential liability of corporations to option traders, stating that such concerns were either incorrect or not matters for the courts. 841 F.2d at 507-08 (App. 11a-13a). The fact is that the concerns are serious and militate strongly in favor of a result which imposes sensible limitations on the class of potential plaintiffs. Moreover, since the private right of action under Section 10(b) and Rule 10b-5 is the result of judicial implication, this kind of expansion should be of major concern to this Court.

A. Option Traders Contribute Nothing To The Corporation.

The Third Circuit declared itself "not willing to construe section 10(b) as inapplicable to option contracts on the basis of speculation about the relationship between option contracts, market liquidity, and capital formation." 841 F.2d at 508 (App. 13a). While the effect of options in creating market liquidity may be debated, there is no speculation required as to their role in capital formation. Options have no role in capital formation. Common stock represents an investment in the corporation. Common stock is issued to raise capital and it represents an ownership interest in the corporation. Options do none of these things, and as to that there can be no serious argument.

The fact that options traders are not investors in the corporation was considered an important policy factor by the court in *Bianco v. Texas Instruments, Inc.*, *supra*:

> Options traders . . . are not investors in the corporation making misleading statements, nor do they purchase or sell that corporation's securities. Their transactions in options contracts are simply too remote to satisfy the "in connection with" requirement when the alleged deceptive acts are merely corporate misstatements not directed in any way to the options market.

627 F. Supp. at 161. The court went on to dismiss plaintiff's counter argument that this result would encourage corporate fraud by noting that "whatever deterrent purpose is served by § 10(b) and Rule 10b-5 will be amply fulfilled by restricting liability for misrepresentations

and omissions to persons trading in the common stock of the corporation." *Id.*

The inherent inequity of providing a cause of action against a corporation for losses suffered by an option trader is made plain by the fact that the corporation has no control over whether options are even issued, let alone in what amount. While the corporation can decide how many shares of common stock to issue, "issuers of underlying stocks do not participate in the selection of their stocks for options trading . . . [and] have no responsibility regarding the issuance, the terms, or the performance of the options . . . ." OCC Booklet, *supra*, note 3, at 71. If the Third Circuit's decision is not reversed, a corporation is subject to virtually unlimited liability over which it would have no control.

B. The Third Circuit's Opinion Forces A Corporation's Stockholders To Pay For Reducing The Risks of Option Traders.

The result reached by the Third Circuit is also fundamentally unfair. Contrary to the Third Circuit's claim, 841 F.2d at 507 (App. 11a-12a), the limitations on potential plaintiffs by virtue of the "actual purchase or sale" requirement of the *Birnbaum* rule or the proximate cause requirement of *Peil v. Speiser*, are not sufficient. If someone dealing in *any* security can plead only some "but for" causal connection, no matter how tenuous, between his loss and alleged misstatements by a putative defendant, then liability under Rule 10b-5 is limited only by the imagination of the financial industry in creating new security instruments based in any way on a corporation's performance. *See Bianco*, *supra*, 627 F. Supp. at 161 ("potential liability to options holders is

limited only by the whims of the options writers").[8] For the courts to give that kind of blank check to the creators of new securities, with the corporation ultimately acting as the banker, is frightening.

As several courts have recognized, the vast expansion of the class of potential plaintiffs will result in judgments and litigation costs that will be borne squarely by those who were intended to be protected by the securities laws, namely the stockholders of the corporation. *E.g.*, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969); *Starkman v. Warner Communications, Inc.*, 671 F. Supp. 297, 307 (S.D.N.Y. 1987); *Bianco v. Texas Instruments, Inc.*, 627 F. Supp. 154, 161 (N.D. Ill. 1985). The perverse irony of the Third Circuit's ruling is that the "especial class" sought to be protected by the Exchange Act would, instead, be directly burdened by the Rule. *See Piper v. Chris-Craft Indus., Inc., supra*, at 39.

The real vice created by the Third Circuit, however, is that the expense to stockholders of financing the litigation the lower court's decision will spawn is not limited to those cases where the corporation is ultimately found to have violated the securities laws. As this Court has recognized, "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from

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8 As the Third Circuit points out, options have been traded for years, but their use was limited until the advent of the Chicago Board Options Exchange in 1973. Since then options on over 400 stocks are traded, with a volume of over 118 million contracts. 841 F.2d at 504 (App. 5a).

that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739.

> The first of these concerns is that in the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment.

Id. at 740. Without proper limitations on the class of plaintiffs who can bring securities actions against corporations, inefficiencies and misallocations of capital will no doubt result. Each decision regarding disclosure must be made with the fear of exposure to "liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179-180, 174 N.E. 441, 444 (1931) (Cardozo, C.J.), *quoted with approval in Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 748 (1975).

The Third Circuit also misperceived the petitioners' argument regarding the speculative nature of options trading. Petitioners do not contend, as the court stated, that because option traders are "'gamblers' . . . they are fair game for affirmative misrepresentation while stock traders are not." 841 F.2d at 507 (App. 12a). Rather, petitioners maintain that because option traders have made a decision to invest their money not in Beneficial -- which investment would carry with it certain inherent

rights, protections and duties running to the investor -- but in a different security known for its high risk and its potentially high profits, *see generally* OCC Booklet, *supra*, note 3, they are not entitled to the same protection as stockholders, at the stockholders' expense.

Petitioners are not asking this Court to hold option traders are "fair game." Indeed, it is difficult to see any reason why Beneficial would care about the price at which options on its securities were trading. The point is that it is appropriate to hold Beneficial responsible to those who have invested in it and to limit its responsibility to those who have not. The result reached by the Third Circuit now makes corporations "fair game." An investor who purchases options which later expire without value will no doubt be encouraged by the result below to invest in a new venture -- a lawsuit against the corporation for alleged misstatements which, when coupled with the usual boilerplate class action allegations, will then provide the option investor with a new asset whose settlement value is limited only by the amount of ruinous damages that can be pleaded.

Finally, and ironically, the Third Circuit has bestowed upon the holders of options the same protection for which stockholders have paid a premium, thus reducing the option trader's risk at the expense of stockholders. Corporations and their investors are, as a result, now even more subject to the long-recognized danger "that a slip of the pen or failure properly to amass or weigh the facts -- all judged in the bright gleam of hindsight -- will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969). The intent behind Rule 10b-5 was "not to establish a scheme of inves-

tors' insurance," much less to establish a scheme to insure a new class of non-investors. *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). Yet the Third Circuit, with its decision in this case, has done exactly that. Such a result, especially in the face of a decision by another Court of Appeals in conflict with the result below, requires review by this Court.

CONCLUSION

For the foregoing reasons Petitioners respectfully submit that the petition for a writ of certiorari should be granted and the case set for oral argument.

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DATED: July 5, 1988

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 87-3570

ROBERT M. DEUTSCHMAN,
Appellant

v.

BENEFICIAL CORP.,
FINN M. W. CASPERSEN,
ANDREW C. HALVORSEN

(D.C. Civil No. 86-00595)

ON APPEAL FROM THE UNITED STATES DISTRICT
COURT FOR THE DISTRICT OF DELAWARE

Argued: January 20, 1988
Before: GIBBONS *Chief Judge*, and
WEIS and GREENBERG, *Circuit Judges*

(Opinion Filed: March 7, 1988)

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OPINION OF THE COURT

GIBBONS, *Chief Judge*.

Robert M. Deutschman appeals from a Fed. R. Civ. P. 12(b)(6) dismissal of his amended class action complaint against Beneficial Corporation (Beneficial), Finn M. W. Caspersen, Beneficial's Chairman and Chief Executive Officer, and Andrew C. Helvorsen, its Chief Financial Officer. The two count complaint alleges that the defendants violated (1) section 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b),78t(a) (1982), and (2) the state common law of negligent misrepresentation. Deutschman, a purchaser of call options on Beneficial stock, seeks to act as a class representative for purchasers of such call options and for purchasers of Beneficial stock. The district court held that the purchaser of a call option lacks standing to sue under the Securities Exchange Act, and is thus not an appropriate class representative for purchasers of Beneficial stock. Because the federal claim was dismissed on standing grounds, the pendent state law claim was dismissed as well. We will reverse.

Since the order appealed from granted a Rule 12(b(6) motion, we accept as true the factual allegations of Deutschman's amended complaint. Deutschman alleges that in 1986 and part of 1987 Beneficial's insurance division suffered severe losses which had an adverse impact on Beneficial's financial condition; that Caspersen and Halversen held stock and stock options in Beneficial which would be adversely affected by a decline in the market price of that stock; that disclosures were made about the losses in Beneficial's insurance division which caused declines in that market price; that in order to prevent further declines Caspersen and Halversen, on Beneficial's behalf,

issued statements about the problems in the insurance division, which they knew to be false and misleading, to the effect that those problems were behind it and were covered by sufficient reserves; that these misleading statements placed an artificial floor under the market price of Beneficial stock; that purchasers of Beneficial stock and purchasers of call options in Beneficial stock made purchases at prices which were artificially inflated by the market's reliance on defendant's misstatements, and that both purchasers of Beneficial stock and purchasers of Beneficial call options suffered losses as a consequence. Beneficial stock is traded on the New York Stock Exchange and on other national stock exchanges. Options on Beneficial stock are traded on the Pacific Stock Exchange. The complaint does not allege that Beneficial, Caspersen, or Halversen, during the time period complained of, traded in Beneficial stock or in put or call options on Beneficial stock. It alleges that Deutschman suffered losses when, upon disclosure of the facts, call options on Beneficial's stock that he had purchased in reliance on the market price created by defendants' misstatements, became worthless. It does not allege that Deutschman purchased Beneficial stock.

The district court held that option traders who suffered losses as a result of intentional misstatements by the management of a corporation, the stock of which is the subject of those options, lack standing to assert a cause of action for damages under section 10(b) of the 1934 Act, 15 U..C. § 78j(b), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5. The court reasoned that in the absence of an allegation that Deutschman bought or sold Beneficial stock, or of an allegation that the defendants bought or sold options, there was no duty owed to him

to refrain even from affirmative misstatements which would affect the market price of Beneficial stock.

Put and call options have been a feature of the national financial markets since 1790. Under these contracts a seller agrees to sell or a purchaser agrees to buy a security at a fixed price on or before a fixed date in the future. Such contracts permit investors to hedge against future movements in the market price of securities. Prior to the early 1970's the utility of put and call options was limited because of high transaction costs, and because of the absence of a secondary market for the option contracts. In 1973, the Chicago Board Options Exchange became the first registered exchange for trading in option contracts. Within a short time that exchange had been joined by the American, Philadelphia, Pacific, and Midwest exchanges. By 1985, those exchanges were trading options on over 400 stocks, and the volume of contracts traded exceeded 118.6 million. *See* Green, Stock Option Trading Gains Popularity as Takeovers and Hedging Spur Surge, *Wall St. J.*, July 23, 1986, at 35, col. 1.

The option contract gives its owner the right to buy (call) or sell (put) a fixed number of shares of a specified underlying stock at a given price (the striking price) on or before the expiration date of the contract. For this option a premium is paid, and the contract is worth more or less than the premium depending upon the direction of the market price of the underlying stock relative to the striking price. The market price for options is directly responsive, therefore, to changes in the market price of the underlying stock, and to information affecting that price. *See generally*, Rubenstein, An Economic Evaluation of Organized Option Markets, 2 J. of Comp. Corp. Law and Sec. Reg. 49 (1979).

Because the market value of an option contract is responsive to changes in the market price of the underlying stock, holders of option contracts are susceptible to two separate types of deceptive practices: insider trading and affirmative misrepresentation. Insiders trading on undisclosed material information can injure option holders either by market activity which causes the price of the underlying stock to move, or by market activity directly in the options market. Insiders or others who do not trade in either market can injure option holders by misstating material facts to the public, thereby causing a distortion in the market price of the underlying security, and in the necessarily related market price of the option contract. Only the second type of harm is pleaded by Deutschman: affirmative misrepresentation by corporate managers having the effect of artificially supporting the market price of the underlying stock, and concomitantly the market price of the option contract for that stock.

Section 10(b) prohibits the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j(b). The relevant SEC rule provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made,

in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1987). The defendants do not deny that the affirmative misrepresentations pleaded by Deutschman would, if proved, amount to untrue statements of material fact which would operate to deceive a purchaser of Beneficial stock. The complaint alleges that the misrepresentations were made intentionally or with reckless disregard of the truth. It, therefore, satisfies the section 10(b) scienter requirement. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). Thus defendants do not dispute that even though they did not trade in Beneficial stock they could, if Deutschman's allegations are proved, be held liable in a suit by a purchaser of such stock. *See, e.g., Peil v. Speiser*, 806 F.2d 1154 (3d Cir. 1986) (stock purchaser can recover damages under section 10(b) for misstatements by corporation and its officers); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971) (seller can recover under section 10(b) for loss on sale induced by corporation's misleading press release). Finally, defendants do not dispute that Deutschman is a purchaser of a security. Congress placed that question beyond debate when, in the Act of Oct. 13, 1982, P.L. 97-303, § 2, Stat. 1409, it amended the Securities and Exchange Act of 1934 and other federal statutes so as explicitly to include option contracts.[1] In contrast with

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1. 15 U.S.C. § 78c(a)(10) currently provides:

The term "security" means any note, stock, treasury

the cause of action for sale of unregistered securities under section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1934 Act), "a § 10(b) action can be brought by a purchaser or seller of '*any* security' against '*any* person' who has used '*any* manipulative device or contrivance' in connection with the purchase or sale of a security." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983) (emphasis in original).

The only standing limitation recognized by the Supreme Court with respect to section 10(b) damage actions is the requirement that the plaintiff be a purchaser or seller of a security. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 959 (1952). When in *Manor Drug Stores* the Supreme Court adopted the *Birnbaum*

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stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, *any put, call, straddle, option, or privilege on any security*, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing, but shall not include currency or any note, draft bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

The italicized language was added by Pub. L. 97-303.

requirement that a section 10(b) plaintiff be a purchaser or seller of a security, however, it expressly recognized that such plaintiffs need not be in any relationship of privity with the defendant charged with misrepresentation. 421 U.S. at 745. The underlying purpose of the 1934 Act was the protection of actual participants in the securities markets, and the *Birnbaum* rule was consistent with that purpose because it limited "the class of plaintiffs to those who have at least dealt in the security to which the prospectus, representation, or omission relates." *Id.* at 747.

Deutschman's complaint appears, therefore, to satisfy every requirement for a section 10(b) damage action imposed by the Supreme Court when dealing with affirmative misrepresentations which may affect the market price of a security. The district court nevertheless dismissed it. The court acted in reliance on *Chiarella v. United States*, 445 U.S. 222 (1980), and *Dirks v. Securities & Exchange Comm.*, 463 U.S. 646 (1983), construing those cases as limiting exposure to liability for damages under section 10(b) to persons in some special relationship of trust or confidence toward the section 10(b) plaintiff.

The district court's reliance on *Chiarella* and *Dirks* is entirely misplaced. Those cases dealt not with injury caused by affirmative misrepresentations which affected the market price of securities, but with the analytically distinct problem of trading on undisclosed information; a theory of recovery which Deutschman does not plead. The "disclose or abstain from trading" rule laid down in the insider trading cases imposes on insiders a duty to disclose information which need not otherwise be disclosed before they act on that information in any uninformed marketplace. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d. Cir.

1968), *cert. denied*, 394 U.S. 976 (1969). Market participants who are neither insiders nor fiduciaries of another type need not disclose material facts, but can rely on the assumption that all other participants have equal access to information. *See General Time Corp. v. Talley Industries, Inc.*, 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969). *Chiarella* and *Dirks* involve only the question of when outsiders and nonfiduciaries will be treated as insiders or fiduciaries for purposes of the affirmative duty to disclose or refrain from trading. The court in those cases declined to extend the duty to disclose or abstain to mere tippees who came into possession of otherwise undisclosed information. Nothing in those opinions, however, can be construed to require the existence of a fiduciary relationship between section 10(b) defendant and the victim of that defendant's affirmative misrepresentation. Except to the extent that other federal statutes may have imposed a disclosure obligation (none are relied on by Deutschman), Beneficial and its officers were free to keep quiet about its business affairs so long as they stayed out of the market. According to Deutschman, however, they chose to speak, and in speaking they were not free to lie.

The district court also relied upon *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983), a case which we find quite distinguishable. In *Laventhall* no misstatements were made to the public. Instead, the defendant corporation, without disclosure, traded in its own securities after a decision had been made to change its dividend policy. The plaintiff option trader sought to hold the corporation liable for the loss he incurred in the options market because he purchased without knowledge of the impending change in the dividend

policy. The Court of Appeals for the Eighth Circuit held that he could not recover on an insider trading theory of liability absent some transactional nexus between the nondisclosure and the market for options. *Id.* at 412. The reasoning of the *Laventhall* case with respect to insider trading liability has been tellingly criticized. Note, *Private Causes of Action for Option Investors under SEC Rule 10b-5: A Policy, Doctrinal, and Economic Analysis*, 100 Harv. L. Rev. 1959 (1987). We need not address that criticism here, however, for the *Laventhall* holding, like the *Chiarella* and *Dirks* holdings, is simply not relevant to the distinct issue of affirmative misrepresentations affecting a market in securities. No Supreme Court case and no Court of Appeals case has ever imposed a transactional nexus requirement in a section 10(b) affirmative misrepresentation case. *But see Bianco v. Texas Instruments*, 627 F.Supp. 154 (N.D. Ill. 1985) (corporation not liable to option trader for affirmative misrepresentation). *Compare In re Digital Equip. Corp. SEC Litig.*, 601 F. Supp. 311 (D. Mass. 1984) (corporation liable to option trader for affirmative misrepresentation); *Lloyd v. Industrial Bio-Test Laboratories*, 454 F.Supp. 807 (S.D.N.Y. 1978) (same).

The defendants urge, nevertheless, that policy reasons require that they be insulated from liability to option traders because otherwise there would be no end to their liability. This argument is chimerical. When in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the Supreme Court adopted the *Birnbaum* rule limiting section 10(b) plaintiffs to purchasers or sellers of securities, it confined section 10(b) liability to members of the precise class for the protection of which the 1934 Act was enacted: participants in the national securities markets. Options traders are participants in those markets. The

same degree of protection against unlimited liability to that class as is afforded with respect to other kinds of tortious conduct is also afforded to the defendant by the proximate cause requirement delineated in cases such as *Piel v. Speiser*, 806 F.2d 1154 (3d Cir. 1986). The spector of unlimited liability to persons outside that class was exorcised by the Supreme Court in *Manor Drug Stores*.

Another policy argument advanced by the defendants is that although purchasers of option contracts do purchase securities they are entitled to less protection under the 1934 Act because option trading, like blackjack or craps, is "gambling." By characterizing option traders as "gamblers" the defendants hope that we will draw the conclusion that they are fair game for affirmative misrepresentation, while stock traders are not. We are not persuaded that the difference between trading in the two types of securities should lead to different treatment. Since the price of option contracts is closely dependent upon the price of the underlying stocks, the degree of risk involved in trading in one over the other is not self-evidently greater. The time element of a put or call option does increase exposure to price movements, but the ability to buy or sell such options in the interim does not. Moreover, the availability of option contracts permits traders in common stocks to engage in hedging transactions, which are often used as means of reducing exposure to market fluctuations and are thus risk reducing. This method of risk reduction, formerly available only through put and call options in an over-the-counter market, has since 1973 been available at lower cost. Finally, it is not our role as a court to pass judgment on the soundness of the legislative policy judgments which led to the creation of exchanges for option contracts, and their treatment as

securities. Congress, the Securities and Exchange Commission, the Board of Governors of the Federal Reserve System, and the Commodity Futures Trading Commission all have had a role in the evolution of the market for these securities, and the policy judgment was their responsibility, not ours.

A final point advanced in support of the district court's ruling is that option traders are not entitled under section 10(b) to protection against affirmative misrepresentation because they play no role in capital formation. We are willing to assume, arguendo, that a chief reason for federal regulation of securities markets is that the existence of those markets, post-issue, tends to make capital available to issuers of securities. It is not at all clear to us, however, that the options contract market contributes to liquidity in the post-issue market in a manner significantly different than does the market for stocks, especially when margin trading of stocks is taken into account. Thus we are not willing to construe section 10(b) as inapplicable to option contracts on the basis of speculation about the relationship between option contracts, market liquidity, and capital formation. The legislative policy judgment in this respect is not ours to make.

We hold that Deutschman has standing as a purchaser of an option contract to seek damages under section 10(b) for the affirmative misrepresentations he alleges were made by the defendants, Beneficial, Caspersen, and Halvorsen. The judgment dismissing Deutschman's section 10(b) claim must therefore be reversed. Since Deutchman's pendent state law claim was dismissed only because jurisdiction was predicated on 28 U.S.C. § 1331, the dismissal of that claim must also be reversed.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF DELAWARE

Civil Action No. 86-595 MMS

ROBERT M. DEUTSCHMAN,

Plaintiff,

—v.—

BENEFICIAL CORPORATION, FINN M. W. CASPERSEN, and ANDREW C. HALVORSEN,

Defendants.

PAMELA S. TIKELLIS, ESQ. of Biggs & Battaglia, Wilmington, Delaware; *Of Counsel*; RICHARD B. DANNENBERG, ESQ., Richard Bemporad, Esq., and Jill Raskin, Esq., of Lowey, Dannenberg & Knapp, P.C., New York, New York; *attorneys for plaintiff Robert M. Deutschman.*

CHARLES F. RICHARDS, JR., ESQ., SAMUEL A. NOLEN, ESQ., and KEVIN G. ABRAMS, ESQ., of Richards, Layton & Finger, Wilmington, Delaware; *attorneys for defendants Beneficial Corporation and Finn M. W. Caspersen*; *Of Counsel*; Dewey, Ballantine, Bushby, Palmer & Wood, New York, New York, *for defendant Finn M. W. Caspersen.*

STEPHEN P. LAMB, ESQ., of Skadden, Arps, Slate, Meagher & Flom, Wilmington, Delaware; *attorney for defendant Andrew C. Halvorsen.*

OPINION

Dated: July 30, 1987
Wilmington, Delaware

MURRAY M. SCHWARTZ, Chief Judge

The last decade has been one of dramatic change and growth in the securities market. One evolution has been the emergence and dynamic rise of trading in options. Not surprisingly, the options market has spawned a host of legal issues. The pivotal question treated in this opinion is whether options traders have standing to bring a cause of action under section 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities and Exchange Commission ("SEC"), 17 C.F.R. § 240.10b-5.

Plaintiff Robert M. Deutschman, an options trader, on November 25 and December 12, 1986, purchased listed call option contracts on the common stock of defendant Beneficial Corporation ("Beneficial") at a cost of $14,229. On December 16, 1986, the option contracts had lost 99.8 percent of their value. On December 22, 1986, plaintiff filed a complaint and on March 5, 1987, filed an amended complaint naming Beneficial as a defendant along with Finn M.W. Caspersen and Andrew C. Halvorsen, respectively chairman of the board of directors and chief executive officer of Beneficial. The amended complaint is based on sections 10(b) and 20(a) of the 1934 Act, 15 U.S.C. §§ 78j(b), 78t(a), and Rule 10b-5.

Count I of the amended complaint alleges with specificity that defendants made a series of materially false and misleading statements to the investing public, by means of their own statements and reports and through the news media, regarding Beneficial's reinsurance business and loss reserves. Plaintiff alleges defendants violated a duty owing to options traders because defendants either knew or should have known the statements were false when made or failed timely to correct these statements when they knew or were reckless in not knowing the statements were no longer true.

The amended complaint also asserts defendants Caspersen and Halvorsen may be held liable as direct participants, aiders and abettors, or "control persons" under section 20(a) of the 1934 Act. Count II of the amended complaint, relying on pendent jurisdiction, asserts a state law claim for negligent misrepresentation.

The amended complaint states that as a result of adverse disclosures to the investing public on December 16, 1986 "the market price of Beneficial common stock dropped some 20%. On December 16, 1986, the common stock closed at $57 1/8 after trading as low as $54 3/4, having precipitously declined some 20% from its December 12, 1986 closing price of $65." Docket Item 7, ¶ 41. Plaintiff goes on to note that "[t]he market price of Beneficial common stock . . . continued to fall in December, opening on December 19, 1986 at $56, $3 below the close on December 18, 1986, and trading as low as $54.75" and alleges that "the market price of Beneficial common stock would have plunged even further if defendants had not sought to cover up the difficulties suffered in the Company's reinsurance business." *Id.* ¶ 43. The decline in market value of Beneficial shares rendered plaintiff's option contracts worthless.

The amended complaint is also noteworthy for what it does not contain. It is devoid of any allegation that plaintiff had any relationship whatsoever with Beneficial. It makes no allegation that plaintiff ever purchased, sold, or owned shares of Beneficial common stock. Plaintiff does not allege that Beneficial consented to the issuance, purchase, or sale of call options on its common stock on any securities exchange, or that Beneficial was in any way connected with plaintiff's purchase or sale of call options. Nor does the amended complaint allege plaintiff dealt with Beneficial—directly or indirectly—at any time. Finally, plaintiff does not allege that any defendant traded in the options market or bought or sold Beneficial shares during the critical time period when the nondisclosures or misrepresentations were made and the adverse news surfaced.

On March 20, 1987, defendants filed a motion to dismiss the amended complaint. Dismissal under Fed. R. Civ. P. 12(b)(6) is improper unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle

him to relief. *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). Moreover, the Court must accept as true the allegations of the amended complaint, *Cruz v. Beto*, 405 U.S. 319 (1972), and construes them favorably to plaintiff. *Scheuer v. Rhodes*, 416 U.S. 232 (1974).

The motion to dismiss squarely presents the question of whether an options trader has standing to assert a cause of action under section 10(b) of the 1934 Act and SEC Rule 10b-5, where it is not alleged that any of the defendants traded in the underlying stock or in options on the stock. The cases are sharply divided. *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983); *Bianco v. Texas Instruments*, 627 F. Supp. 154 (N.D. Ill. 1985); and *In re McDonnell Douglas Corp. Sec. Litig.*, 567 F. Supp. 126 (E.D. Mo. 1983), hold options traders lack standing. *See Etshokin v. Texasgulf, Inc.*, 612 F. Supp. 1220 (N.D. Ill. 1985). *In re Digital Equip. Corp. Sec. Litig.*, 601 F. Supp. 311 (D. Mass. 1984); *Backman v. Polaroid Corp.*, 540 F. Supp. 667 (D. Mass. 1982); and *Lloyd v. Industrial Bio-Test Laboratories*, 454 F. Supp. 807 (S.D.N.Y. 1978), conferred standing on options traders. In making the standing determination, "[w]e are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited . . . ." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 749 (1975). The Court must address whether the "judicial oak which has grown from little more than a legislative acorn," *id.* at 737, should be engrafted with a new limb from which numerous branches would inevitably sprout. For the reasons that follow, I conclude that options traders lack standing under section 10(b) and Rule 10b-5.

Some background explanation of options is essential to understanding the question of whether options traders have standing to assert a Rule 10b-5 violation.[1] The type of stock options plaintiff Deutschman purchased were call options. The call op-

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1 The summary explanation in the text is gleaned from Seligman, *The Structures of the Options Market*, Fall 1984, Journal of Corporate Law 141. A more comprehensive examination of the options market is contained in that article.

tions, or options to buy, gave plaintiff the right, but not the obligation, to buy Beneficial shares at a preset price. Call options are sold by an options writer who must deliver stock if and when a call option is exercised. The options writer, usually found on a regional options exchange, is paid a premium by options purchasers to assume the obligation to deliver the underlying stock. In this case, plaintiff paid a premium of $14,229 for fifty-five option contracts, which conferred upon him the right to receive 5,500 shares of Beneficial stock.

The purchaser of a call option has two ways to profit from the trading in options on the secondary market. The option may be exercised, earning a profit if the market price of the underlying security exceeds the sum of the exercise price, the premium, and transaction costs. Alternatively, if the price of the underlying security increases the option contract may be sold, earning a profit if the sale price of the contract exceeds the sum of the original premium and transaction costs. The latter alternative is by far the most frequently employed method of earning a profit on options.

Options are a highly leveraged way of making profit by correctly predicting the direction and extent of movement in a particular stock.[2] By the same token, trading in options is far more speculative than purchase of the underlying stock because of the definite and short duration of the contract. If a call option contract cannot be sold because the price of the underlying stock did not rise as far as anticipated, all or part of the premium may be lost.

Defendants argue that because there is no transactional or fiduciary relationship between the options trader and the issuer of the underlying stock, the issuer owes no duty to the options trader under section 10(b) and Rule 10b-5. Defendants rely on *Chiarella v. United States*, 445 U.S. 222, 228-30 (1980), in which the Supreme Court held that a duty to disclose material information arises only if a "relationship of trust and confidence" exists between the defendant and the injured party. The

2 Assuming an average market price per share of $65 during the period in which Deutschman purchased his 55 option contracts, he would have paid $357,500 for the underlying Beneficial stock. Thus, for $14,229 (ignoring a differential in transaction costs), Deutschman was leveraged 25 to one.

defendant in *Chiarella* was a printer who inferred the identity of a corporation that was the target of a takeover attempt from a document sent to his employer for printing. Using this confidential information, the defendant purchased shares in the target corporation, and then sold the shares at a profit immediately after the takeover was made public. The Court found the defendant did not violate section 10(b) and Rule 10b-5, although he purchased shares with improperly obtained inside information, because he was not a corporate insider and was not a fiduciary or agent of the injured sellers. *Id.* at 232-33; *see Dirks v. Securities & Exch. Comm'n*, 463 U.S. 646 (1983).

In *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983), the Eighth Circuit Court of Appeals relied on *Chiarella* in holding that no relationship existed between options traders and the issuer of the underlying stock where the issuing corporation trades in the stock without disclosing material inside information. Although the corporate defendant in *Laventhall* had violated section 10(b) and Rule 10b-5 as to persons also trading in the corporation's stock, there was no "transactional nexus" between the corporation and the plaintiff options traders. *Id.* at 412. Without this transactional nexus, the court held that the duty to disclose does not arise absent "some special relationship" between the plaintiff and defendant in a securities fraud case. *Id.* at 413.

The *Laventhall* rule has been applied to dismiss an action brought by options traders against the issuer of the underlying stock where the issuing corporation traded neither in options nor in the stock, but simply failed to disclose material adverse information. *See In re McDonnell Douglas Corp. Sec. Litig.*, 567 F. Supp. 126 (E.D. Mo. 1983). More importantly for purposes of the instant case, standing has also been denied to options traders where the issuer of the underlying stock engaged in affirmative misrepresentations as opposed to mere nondisclosure. *See Bianco v. Texas Instruments*, 627 F. Supp. 154 (N.D. Ill. 1985). *But see In re Digital Equip. Corp. Sec. Litig.*, 601 F. Supp. 311 (D. Mass. 1984); *Backman v. Polaroid Corp.*, 540 F. Supp. 667 (D. Mass. 1982); *Lloyd v. Industrial Bio-Test Laboratories*, 454 F. Supp 807 (S.D.N.Y. 1978). This Court agrees that securities fraud actions brought by options traders against

issuers of the underlying stock must be dismissed regardless of the type of misconduct alleged.

There is a vast difference between corporate shareholders and options traders. Shareholders own an equity interest in the corporation; options traders do not. Shareholders are involved in desired capital formation; options traders make no contribution to capital or a contribution so attenuated as to be *de minimis*. Although both shareholders and options traders are affected by the corporation's performance, the brute fact is the corporation is run only for the benefit of shareholders, not options traders. The relationship between shareholders and the corporation is one of trust and confidence, giving rise to a duty owed by the corporation. The nonexistence of a relationship between options traders and the corporation precludes such a duty.

In addition to the duty analysis, the Supreme Court's decision in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), squarely supports the denial of standing to options traders.[3] The plaintiffs in *Blue Chip* were offerees of a stock offering made pursuant to an antitrust consent decree. They alleged that affirmative misrepresentations and nondisclosures by the defendant offeror fraudulently induced the offerees not to purchase the stock. The Court denied standing, holding that a private damages action under section 10(b) and Rule 10b-5 is confined to actual purchasers or sellers of securities. *Id.* at 747-49.

Options traders are, of course, purchasers or sellers of securities as the term "security" is defined by section 3(a)(10) of the 1934 Act. 15 U.S.C. § 78c(a)(10); *see Blue Chip*, 421 U.S. at 750-51. The conclusion that plaintiff in the instant case has satisfied the purchaser or seller requirement of *Blue Chip*, how-

3 Other cases in addition to *Blue Chip* and *Chiarella* arguably portend a pronounced trend in the Supreme Court to restrict causes of action under section 10(b) and Rule 10b-5. *See* Aaron v. Securities & Exch. Comm'n, 446 U.S. 680 (1980) (scienter required in SEC injunction actions); Santa Fe Indus. v. Green, 430 U.S. 462 (1977) (no Rule 10b-5 liability for corporate mismanagement or breach of fiduciary duty claims); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (scienter required in Rule 10b-5 damages actions).

ever, does not follow from this premise. *Blue Chip* can only be read as requiring that the plaintiff in a section 10(b) case be an actual purchaser or seller of securities *issued by the defendant corporation*. The call options purchased by plaintiff are securities within the meaning of the 1934 Act, but they are not securities in Beneficial. Like the plaintiffs in *Blue Chip*, plaintiff Deutschman is "a complete stranger to the corporation," 421 U.S. at 755, without standing to assert a section 10(b) violation.

Notwithstanding the obstacles erected by *Chiarella* and *Blue Chip*, plaintiff appears to assert four discrete theories in support of his claim.[4] First, plaintiff alleges defendant is engaged in "manipulative or deceptive" acts in violation of section 10(b) of the 1934 Act. The short answer to this contention is that section 10(b) proscribes manipulative and deceptive acts only "in connection with the purchase or sale of any security." 15 U.S.C. § 78j(b). Similarly, Rule 10b-5 only prohibits fraudulent acts "in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5. There is no allegation that defendants either traded in options on Beneficial stock during the period in question or directed to the options market their alleged misrepresentations and nondisclosures. Plaintiff's trading in option contracts is "simply too remote to satisfy the 'in connection with' requirement when the alleged deceptive acts are merely corporate misstatements [and nondisclosures] not directed in any way to the options market." *Bianco v. Texas Instruments*, 627 F. Supp. 154, 161 (N.D. Ill. 1985).

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4 Plaintiff argues in addition that the interest of options traders in being protected against securities fraud is within the "zone of interests" surrounding section 10(b), and that Congress has therefore conferred standing on plaintiff. *See* Association of Data Processing Serv. Orgs. v. Camp, 397 U.S. 150 (1970). The "zone of interests" test, however, has been applied principally where plaintiffs seek to review administrative action under the Administrative Procedure Act, and is inapposite where Congress has manifested an intent to narrow the class of persons who may sue. *See* Clark v. Securities Indus. Assoc., 55 U.S.L.W. 4111, 4114 n.16 (1987) ("the invocation of the zone of interest test . . . should not be taken to mean that the standing inquiry under whatever constitutional statutory provision a plaintiff asserts is the same as it would be if the 'generous review provisions' of the APA apply").

Second, plaintiff argues section 10(b) imposes a duty of disclosure that derives from a common law duty to disclose where a corporation has made prior statements on a topic. Therefore, the argument goes, defendants were under a duty to speak the whole truth when undertaking to speak at all and a duty to correct or revise a prior statement that was accurate when made but which became misleading in light of subsequent events. The obvious weakness of this theory is that establishing a duty of disclosure sheds no light on the question of to whom the duty is owed.

Third, plaintiff relies on the "fraud on the market" theory, stated in the amended complaint and recently adopted by the Third Circuit Court of Appeals, to establish a duty owed to option traders. In *Peil v. Speiser*, 806 F.2d 1154 (3d Cir. 1986), the Court of Appeals explained:

> The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. The misstatements may affect the price of the stock, and thus defraud purchasers who rely on the price as an indication of the stock's value. By artificially inflating the price of the stock, the misrepresentations defraud purchasers who rely on the price as an indication of the stock's value. *The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.* In both cases, defendants' fraudulent statements or omissions cause plaintiffs to purchase stock they would not have purchased absent defendants' misstatements and/or omissions.
>
> Accordingly, we hold that plaintiffs who purchase in a open and developed market need not prove direct reliance on defendants' misrepresentations *but can satisfy their burden of proof on the element of causation* by showing that the defendants made material misrepresentations.

Id. at 1160-61 (citation and footnote omitted; emphasis added). The price of call options is closely tied to the price of the underlying stock; the Court therefore assumes without deciding the fraud on the market theory would be applicable to claims by options traders. Moreover, plaintiff properly alleges that defendants' materially false and misleading statements artificially inflated the price of call options on Beneficial stock just as they artificially inflated the price of the stock itself.

Pleading the fraud on the market theory, however, does not give rise to a duty owed by defendants to options traders. The theory is no more or less than an alternative method of proving the causal connection between misrepresentations and nondisclosures, on the one hand, and the plaintiff's injury, on the other. It has no bearing on the relationship between options traders and the issuer of the underlying stock that must exist before the causation element can even come into play. I hold that the fraud on the market theory does not impose on Beneficial a duty owing to plaintiff.

Fourth, plaintiff asserts that defendants owed a duty to the investing public, which includes options traders. As I understand plaintiff's theory, it is based on the unarticulated premise that the federal securities laws have created an absolutely level playing field in which all investors have a right to all information necessary to make investment decisions. Plaintiff reasons that his right as a member of the investing public was violated because defendants' misrepresentations were aimed at the securities market in general,[5] and it was foreseeable that the investing public would rely on them.

Several weaknesses plague plaintiff's duty to the investing public theory. Beneficial, like other corporations on whose stock options are traded, does not control the number of option contracts that may be written; its potential liability to options traders is limited only by the business judgments of options writers. As Chief Judge Cardozo observed, caution is the watchword where the creation of a duty results in "a liability in

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5 In support of this claim, plaintiff alleges that the misrepresentations were not confined to corporate letters or reports to shareholders, but were also in articles in the Wall Street Journal and press releases intended for the investing public in general.

an indeterminate amount for an indeterminate time to an indeterminate class." *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931). Moreover, if plaintiff is granted standing in this case, the ultimate recovery could only be paid by Beneficial and its shareholders. Such an expansion of corporate liability "will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers . . . ." *Securities & Exch. Comm'n v. Texas Gulf Sulphur Co.* 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969). There is no reason why options traders, who have chosen a greater risk in exchange for the prospect of a greater return, and who do not meaningfully contribute to capital formation, should recover at the expense of the corporation's shareholders. Finally, restricting liability for misrepresentations and nondisclosures to purchasers and sellers of the corporation's stock amply serves the deterrent purposes of section 10(b) and Rule 10b-5. *See Bianco v. Texas Instruments*, 627 F. Supp. 154, 161 (N.D. Ill. 1985).

For the foregoing reasons, I respectfully disagree with the holdings of *In re Digital Equip. Corp. Sec. Litig.*, 601 F. Supp. 311 (D. Mass. 1984); *Backman v. Polaroid Corp.*, 540 F. Supp. 667 (D. Mass. 1982); and *Lloyd v. Industrial Bio-Test Laboratories*, 454 F. Supp. 807 (S.D.N.Y. 1978). I hold that an options trader is without standing to assert a cause of action under section 10(b) of the 1934 Act and SEC Rule 10b-5, where it is not alleged that the defendants traded in the underlying stock or in options on the stock. An order will be entered dismissing Count I of the amended complaint.[6] The order will also dismiss for lack of jurisdiction the pendent state law claim in Count II of the amended complaint. *See United Mine Workers v. Gibbs*, 383 U.S. 715 (1966).

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6 The claim against defendants Caspersen and Halvorsen under section 20(a) of the 1934 Act, of course, falls with the claim against Beneficial.

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF DELAWARE

Civil Action No. 86-595 MMS

ROBERT M. DEUTSCHMAN,

Plaintiff,

v.

BENEFICIAL CORPORATION, FINN M. W. CASPERSEN, and ANDREW C. HALVORSEN,

Defendants.

ORDER

At Wilmington this 30th day of July, 1987, for the reasons set forth in the Opinion issued this date,

IT IS ORDERED:

1. Count I of the amended complaint is dismissed.

2. The pendent state law claim in Count II of the amended complaint is dismissed for lack of jurisdiction.

/s/ MURRAY M. SCHWARTZ
United States District Judge

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 87-3570

ROBERT M. DEUTSCHMAN,

Appellant

—v.—

BENEFICIAL CORP. FINN M. W. CASPERSEN
ANDREW C. HALVORSEN

(D.C. Civ. No. 86-00595)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE -- DISTRICT OF DELAWARE

Present:

GIBBONS, *Chief Judge*
WEIS and GREENBERG, *Circuit Judges*

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the -- District of Delaware and was argued by counsel January 20, 1988.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court entered July 30, 1987, be, and the same is hereby reversed. Costs taxed against the appellees.

ATTEST:

SALLY MRVOS, *Clerk*

March 7, 1988

Certified as a true copy and issued in lieu of a formal mandate on April 12, 1988.

Test: M. ELIZABETH FERGUSON

Chief Deputy Clerk, U.S. Court of Appeals for the Third Circuit.

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 87-3570

ROBERT M. DEUTSCHMAN,

Appellant

—v.—

BENEFICIAL CORPORATION, FINN M. W. CASPERSEN, ANDREW C. HALVORSEN

SUR PETITION FOR REHEARING

Present: GIBBONS, *Chief Judge*, SEITZ, WEIS, HIGGINBOTHAM, SLOVITER, BECKER, STAPLETON, MANSMANN, GREENBERG, HUTCHINSON, SCIRICA, AND COWEN, *Circuit Judges*.

The petition for rehearing filed by appellant in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court en banc, the petition for rehearing is denied.

By the Court,

JOHN J. GIBBONS
Chief Judge

Dated: April 4, 1988

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, Title 15, United States Code

§ 78j. Manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities and Exchange Commission Rule 10b-5, Title 17, Code of Federal Regulations

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

No. 88-36 (2)

In the

Supreme Court of the United States

October Term, 1988

BENEFICIAL CORPORATION,
FINN M.W. CASPERSEN, ANDREW C. HALVORSEN,

Petitioners,

— against —

ROBERT M. DEUTSCHMAN,

Respondent.

BRIEF FOR RESPONDENT IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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66 pp

QUESTION PRESENTED

Does a plaintiff who purchased securities on a national securities exchange, namely call options to purchase common stock of Beneficial Corporation ("Beneficial"), have standing under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, to bring an action for securities fraud, arising from affirmative misrepresentations made by Beneficial and its chief executive and financial officers, relating to the business, operations, and financial condition and results of Beneficial, where those affirmative misrepresentations artificially inflated the market price of the common stock of Beneficial and the market price of call options to purchase that common stock?

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

BENEFICIAL CORPORATION,
FINN M.W. CASPERSEN, ANDREW C. HALVORSEN,

Petitioners,

— against —

ROBERT M. DEUTSCHMAN,

Respondent.

BRIEF FOR RESPONDENT IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Respondent Robert M. Deutschman respectfully requests that this Court deny the Petition for Certiorari to the United States Court of Appeals for the Third Circuit (the "Petition") submitted by Beneficial Corporation ("Beneficial") and the two individual petitioners (collectively, the "Petitioners") to review a judgment of the United States Court of Appeals for the Third Circuit. The judgment reversed the Order of the United States District Court for the District of Delaware granting Petitioners' motion to dismiss the Respondent's complaint for lack of standing and jurisdiction.

STATEMENT OF THE CASE

Respondent's Amended Complaint is brought under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78(j)(b), 78(t)(a) (the "Exchange Act") and Securities and Exchange Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission ("SEC"), 17 C.F.R. 240.10b-5. Respondent brings this action as a class action pursuant to Rules 23(a) and (b)(3) of the Federal Rules of Civil Procedure on behalf of a class consisting of all persons who purchased the common stock of Beneficial during the period August 21, 1986 through February 27, 1987, or purchased call option contracts thereon during that period, and have sustained a loss. There have been no rulings or proceedings as to class certification.

Issue has not been joined. On March 27, 1987, Petitioners filed a motion to dismiss pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure on the grounds that (i) Respondent, a purchaser of Beneficial call option contracts, lacks standing under Section 10(b) of the Exchange Act and Rule 10b-5; (ii) the Amended Complaint fails to state a claim upon which relief can be granted; and (iii) there is no pendent jurisdiction over the common law claim of negligent misrepresentation.

Discovery was deferred pending a ruling by the District Court on the motion to dismiss. Limited discovery is now proceeding in the District Court. Should this Court grant the Petition for Certiorari, however, discovery will be automatically stayed pursuant to rulings of the Court made on June 20, 1988.

On July 30, 1987, the District Court dismissed the Amended Complaint, holding that (i) Respondent has no standing under the federal claim and, therefore, (ii) the District Court lacks jurisdiction over the pendent state law claim. *Deutschman v. Beneficial Corp.*, 668 F.Supp. 358, 364 (D. Del. 1987)(App. 25a).[1]

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[1] References to "App ____" are to Petitioners' Appendix. Respondent's Amended Complaint is reproduced in the Appendix to this brief and will be referred to as "Resp. App. ____".

Apart from the issue of standing, the Court did not pass on whether the Amended Complaint fails to state a claim upon which relief can be granted.

On March 7, 1988, the United States Court of Appeals for the Third Circuit reversed the District Court, holding that Respondent, a purchaser of a call option, which concededly is a security, has standing to seek damages under Section 10(b) for securities fraud arising from the affirmative misrepresentations made by Petitioners relating to the business, operations, and financial condition and operating results of Beneficial, where the affirmative misrepresentations artificially inflated the market price of the common stock of Beneficial and of call options to purchase that common stock. In so finding, the Court of Appeals expressly accepted the fact that changes in the market value of an option contract correlate directly to changes in the market price of the underlying stock. *Deutschman v. Beneficial Corp.*, 841 F.2d 502, 504, 505, 507-508 (3d Cir. 1988). (App. 6a, 12a).

The Court of Appeals held that Respondent's "complaint appears . . . to satisfy every requirement for a Section 10(b) damage action imposed by the Supreme Court when dealing with affirmative misrepresentations which may affect the market price of a security." *Id.* at 506. (App. 9a).[2]

The Court of Appeals properly accepted as true the factual allegations of the Amended Complaint in considering the District Court's ruling under Rule 12(b)(6). In this regard:

> . . . Deutschman alleges that in 1986 and part of 1987 Beneficial's insurance division suffered severe losses

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[2] Petitioners did not raise below any issue as to the materiality of the affirmative misrepresentations; nor did they claim the Amended Complaint fails sufficiently to plead fraud with specificity; nor did the Petitioners challenge that Respondent was in fact a purchaser of a security or the applicability of the now accepted and well-recognized fraud-on-the-market theory. *Basic v. Levinson*, ____ U.S. ____, 108 S.Ct. 978, 988-992 (1988). Apart from the controverted issue of standing, it cannot be denied that Count I of Respondent's Amended Complaint sufficiently states a federal claim.

which had an adverse impact on Beneficial's financial condition; that Caspersen and Halvorsen held stock and stock options in Beneficial which would be adversely affected by a decline in the market price of that stock; that disclosures were made about the losses in Beneficial's insurance division which caused declines in that market price; that in order to prevent further declines Caspersen and Halvorsen, on Beneficial's behalf, issued statements about the problems in the insurance division, which they knew to be false and misleading, to the effect that those problems were behind it and were covered by sufficient reserves; that these misleading statements placed an artificial floor under the market price of Beneficial stock; that purchasers of Beneficial stock and purchasers of call options in Beneficial stock made purchases at prices which were artificially inflated by the market's reliance on defendants' misstatements, and that both purchasers of Beneficial stock and purchasers of Beneficial call options suffered losses as a consequence. Beneficial stock is traded on the New York Stock Exchange and on other national stock exchanges. Options on Beneficial stock are traded on the Pacific Stock Exchange. The complaint does not allege that Beneficial, Caspersen, or Halvorsen, during the time period complained of, traded in Beneficial stock or in put or call options on Beneficial stock. It alleges that Deutschman suffered losses when, upon disclosure of the facts, call options on Beneficial's stock that he had purchased in reliance on the market price created by defendants' misstatements, became worthless. It does not allege that Deutschman purchased Beneficial stock.

Deutschman v. Beneficial, 841 F.2d at 503-504. (App. 3a-4a).

On April 4, 1988, Petitioners filed a petition for rehearing *en banc* which petition was denied by the Court of Appeals on April 4, 1988. (App. 29a).

SUMMARY OF ARGUMENT

The Petition for a Writ of Certiorari should not be granted for the following reasons: (1) the disposition by the Court of Appeals of the question presented was in conformity with applicable decisions of this Court and the legislative intent as expressed in the Exchange Act; (2) no other federal court of appeals has decided the exact question presented and the decision of the Third Circuit does not conflict with any rulings of a Court of Appeals of another Circuit; (3) the Third Circuit's decision below has no serious ramifications beyond the facts alleged with specificity in the Amended Complaint and does not involve an unprecedented expansion of the long-recognized private right of action under Section 10(b) and Rule 10b-5; (4) the question presented, raised in the context of a motion addressed to the legal sufficiency of the claim based on a presently undeveloped factual record, does not involve an important issue of federal law; and (5) Petitioners are improperly seeking advisory opinions of this Court as to irrelevant issues.[3]

The Third Circuit made no sweeping pronouncements. The precise holding of the Court is that a purchaser of an option contract to purchase securities (a "call") has standing to seek damages under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder for affirmative misrepresentations. *Deutschman v. Beneficial*, 841 F.2d at 508 (App. 13a). The decision of the Court applies relevant Supreme Court precedent as well as relevant landmark opinions from various Courts of Appeals. Nothing in the

[3] Given the present posture of this litigation, where issue has not been joined, class certification has not been resolved, and the facts have not been developed, Petitioners' argument as to the "serious ramifications" of the decision of the Third Circuit is strained. (Petition at 2). The flaws in the Petition are evident by the extent to which it contains superfluous matters outside the record relating to such subjects as index options and "uncovered" or "naked" options. (Petition at 9-11). The record does not reflect, nor does the Amended Complaint reflect, that Respondent purchased or wrote naked options or index options or any new kind of investment instrument. As the Third Circuit found, call option contracts, the relevant security, have been traded on national securities exchanges since 1973 and in the unlisted securities market for more than 100 years. *Deutschman v. Beneficial*, 841 F.2d at 504. (App. 5a).

decision conflicts with opinions of this Court or of any Court of Appeals of the United States. Since the decision of the Court of Appeals for the Third Circuit is in conformity with prior law on the question presented, and does not decide any novel issues, no important question of federal law is involved.

Moreover, Petitioners' gratuitous litany of the risks of investing in options, without the benefit of expert testimony, ignores the fact that options trading is beneficial to the economy and the securities markets and can be a risk reducing investment strategy. The description in the Petition of other types of derivative securities is similarly irrelevant to the question presented at bar. This class action does not involve index options or "uncovered" or "naked options" (Petition at 9-11). Respondent only seeks damages for himself and others similarly situated, namely, those who purchased common stock of Beneficial or call options thereon in the impersonal market of national securities exchanges during an approximate six-month period. Petitioners nonetheless would have the Court hold that a purchaser of a call option under no circumstances at any time may bring an action under the 1934 Act — and thereby have the Court disqualify *per se* such an investor's federal claim.

Respondent, a purchaser of securities, is surely one of the primary intended beneficiaries of the Exchange Act, since the purpose of that Act is the protection of investors. The decision below is consistent with that purpose.

ARGUMENT

I.

THE DECISION OF THE COURT OF APPEALS FOR THE THIRD CIRCUIT DOES NOT CONFLICT WITH ANY DECISION OF THIS COURT OR OF ANY OTHER COURT OF APPEALS

A. *Contrary to the Argument of Petitioners, Section 10(b) of the Exchange Act is Intended to Protect Investors Who Purchase Calls On a National Securities Exchange. The Third Circuit So Determined, Consistent with the Decisions of this Court.*

The statutory scheme underlying the Exchange Act intends to afford standing to Respondent to seek redress for actual damages sustained as a result of materially false and misleading reports and press releases disseminated to the investing public by Petitioners. Because protection for option purchasers, like purchasers of common stock, falls within the plain language of the statute; because protection to these securities purchasers is within the intent of Congress; and because such protection is consistent with the legislative intent, an options purchaser has standing to bring an action for fraud under Section 10(b) and Rule 10b-5 against an issuer of the stock, which underlies the option, where that issuer and its officers caused false and misleading reports about the issuer to be disseminated to the investing public.

This Court has recently affirmed that "[j]udicial interpretation and application, legislative acquiescence, and the passage of time have removed any doubt that a private cause of action exists for a violation of §10(b) [of the Exchange Act] and Rule 10b-5 [promulgated thereunder], and constitutes an essential tool for enforcement of the Exchange Act's requirements." *Basic, Inc. v. Levinson*, ____ U.S. ____, 108 S.Ct. 983 (1988) citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975).

> The 1934 Act was designed to protect investors against manipulation of stock prices. See S.Rep. No.

792, 73d Cong., 2d Sess. 1-5 (1934). Underlying the adoption of extensive disclosure requirements was a legislative philosophy: "There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy." H.R.Rep. No. 1383, 73d Cong., 2d Sess., 11 (1934). This Court "repeatedly has described the 'fundamental purpose' of the Act as implementing a 'philosophy of full disclosure.' " *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477-478, 97 S.Ct. 1292, 1303, 51 L.Ed.2d 480 (1977), quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186, 84 S.Ct. 275, 280, 11 L.Ed.2d 237 (1963).

Basic v. Levinson, 108 S.Ct. at 982.

Purchasers of calls, an explicitly defined security under §2 of the Exchange Act,[4] have standing to seek damages for violations of Section 10(b) just as purchasers of common stock do. Unlike other provisions of the federal securities laws,[5] "a Section 10(b) action can be brought by a purchaser or seller of '*any* security' against '*any* person' who has used '*any* manipulative device or contrivance' in connection with the purchase or sale of a security." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983)

[4] In the Act of October 13, 1982, P.L. 97-303, §2, Stat. 1409, Congress amended the Exchange Act to unequivocally include "any put, call, straddle, option or privilege on any security," within the definition of a security. This amendment arose out of a recognition of the proliferation of financial instruments designed to hedge against, among other things, stock market fluctuations and the resulting necessity to clarify and confirm the SEC's authority to regulate trading in such instruments. *See, e.g.*, U.S. Code Cong. and Admin. News, Pub. L. 97-303, at 2780-81. Even prior to the 1982 amendment, however, calls and other options on securities were clearly considered securities for purposes of Section 10(b). *Blue Chip Stamps*, 421 U.S. at 751. *See also Deutschman v. Beneficial*, 841 F.2d at 505, n. 1 (App. 7a). Given the indisputable long and well recognized existence of an implied private right of action under Section 10(b), Congress would have explicitly excluded calls from the "any security" language of Section 10(b), had it wanted to deprive purchasers of calls from seeking damages under Section 10(b). *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 383-87 (1983).

[5] *See, e.g.*, 15 U.S.C. §§77k and 77l.

emphasis in original). Indeed, this Court has repeatedly emphasized that the definition of "security" under the Exchange Act is "quite broad." *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 (1985).

Undoubtedly, Respondent, a purchaser of a call to which the misrepresentations of Petitioners relate, is within the class of persons for whose "especial benefit" Section 10(b) was enacted. *Cort v. Ash*, 422 U.S. 66 (1975).

The purpose of the Exchange Act further supports the intended coverage of Section 10(b) to include purchasers of calls which are traded on a national securities exchange and whose purchasers are as affected by misrepresentations relating to the underlying common stock as the stockholders themselves. "The market price for options is directly responsive [] to changes in the market price of the underlying stock, and to information affecting that price." *Deutschman v. Beneficial*, 841 F.2d at 504 citing Rubinstein, *An Economic Evaluation of Organized Options Markets*, 2 Journal of Comp. Corp. Law and Sec. Reg. 49 (1979) (App. 5a).

Had Respondent purchased 5500 common shares of Beneficial common stock on the New York Stock Exchange on November 25, 1986 and December 12, 1986, instead of 55 call option contracts purchased on those dates, and had Respondent sold the shares at a loss the week of January 12, 1987 when the option contracts expired (Resp. App. 2-3), Respondent unquestionably would have standing to prosecute the action. This would have been so, even though the Respondent would not have dealt with Petitioners, would not have purchased his Beneficial common stock from them but would have purchased those shares in the impersonal trading market of the New York Stock Exchange from some stranger who would have been the recipient of the net proceeds (after commissions) of that purchase. Petitioners would not have benefited one iota from such a transaction, would not have been involved, and could argue as they do here that they had no relationship in that particular transaction with the purchaser.[6]

[6] Hundreds of shares of common stock of Beneficial are traded daily on the New York Stock Exchange not involving Petitioners. Likewise, there are numerous

(Footnote continued)

Nonetheless, the standing of such a purchaser of common stock to prosecute a 10b-5 action is clear. *Basic v. Levinson*, 108 S.Ct. at 983.

The fundamental purpose of implementing a philosophy of full disclosure to promote honest markets dictates that protection be provided to victims of fraud perpetrated on all the securities markets which are linked together and function harmoniously. As explained by one commentator, "the inclusion of call options as securities is even more compelling when one considers the relationship between the call option and the underlying security, because the option holders' financial success is determined by the activity of the underlying stock. The options investor is therefore clearly in the passive role which has classically resulted in SEC protection." Johnson, *Is it Better to Go Naked on the Street? A Primer on the Options Market*, 55 The Notre Dame Lawyer No. 1 at 30 (October 1979).

Notably, Section 20 of the Exchange Act was amended in 1984 in recognition of the intended coverage of the Exchange Act to include manipulations affecting the options market.[7] This enactment is "indicative of contemporary congressional intent to include options investors within the class of beneficiaries of Rule 10b-5. . . ." Note, *Private Causes of Action for Option Investors under SEC Rule 10b-5: A Policy, Doctrinal, and Economic Analysis*, 100 Harv. L. Rev. 1959, 1962 (June 1987). The legislative history of this Insider Trading Sanctions Act reiterates the concern expressed by Congress in 1934, namely that " 'capital

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daily transactions in the Beneficial call option market on the Pacific Coast Exchange not involving Petitioners.

[7] Section 20, 15 U.S.C. §78t, as amended August 10, 1984, Pub. L. 98-376, §5.98 Stat. 1265, provides:

> (d) Liability for trading in securities while in possession of material nonpublic information.
>
> Wherever communicating, or purchasing or selling a security while in possession of material nonpublic information would violate, or result in liability to any purchaser or seller of the security under any provision of this chapter, or any rule or regulation

(Footnote continued)

formation and our nation's economic growth and stability depend on investor confidence in the fairness and integrity of our capital markets.' " *Id.* at 1966, n. 39.[8]

Thus, it would defy the express language and intent of the Exchange Act as well as logic to adopt the aritificial distinction sought by Petitioners vis-a-vis a purchaser of common stock and a purchaser of call options on that stock, both of whom rely on the salutary purposes of the Exchange Act to ensure their protection. As the Court of Appeals for the Third Circuit explained:

> The only standing limitation recognized by the Supreme Court with respect to Section 10(b) damage actions is the requirement that the plaintiff be a purchaser or seller of a security. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.) *cert. denied*, 343 U.S. 959 (1952). When in *Manor Drug Stores* the Supreme Court adopted the Birnbaum requirement that a Section 10(b) plaintiff can be a purchaser or seller of a security, however, it expressly recognized that such plaintiffs need

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thereunder, such conduct in connection with a purchase or sale of a put, call, straddle, option, or privilege with respect to such security or with respect to a group or index of securities including such security, shall also violate and result in comparable liability to any purchaser or seller of that security under such provision, rule, or regulation.

[8] Section 2 of the Exchange Act recites, *inter alia*, that "transactions in securities as commonly conducted upon securities exchanges ... are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters relating thereto ... to require appropriate reports ... and to impose requirements necessary to make such regulation and control reasonably complete and effective ..." 15 U.S.C. 78b. Protection would be less than complete if Respondent had no remedy under the statute. Section 18 of the Exchange Act provides an express cause of action to "any person" who shall have purchased a security at a price affected by a false and misleading filing and who relied on the filing. 15 U.S.C. 78r. Clearly, a purchaser of a call would have standing under that section. This Court has acknowledged that the federal courts have held that an express right of action under Section 18 would not bar an implied right of action under Section 10(b). *Huddleston*, 459 U.S. at 386.

> not be in any relationship of privity with the defendant charged with misrepresentation. 421 U.S. at 745. The underlying purpose of the 1934 Act was the protection of actual participants in the securities markets, and the *Birnbaum* rule was consistent with that purpose because it limited the class of plaintiffs to those who have at least dealt in a security to which the prospectus, representation, or omission relates. *Id.* at 747.

Deutschman v. Beneficial, 841 F.2d at 506 (App. 8a-9a).

B. *This is not an Insider Trading Case. Unlike an Insider Trading Claim, Respondent's Standing to Seek Damages Under Section 10(b) for Affirmative Misrepresentation Requires Neither a Specific Relationship Nor a Transactional Nexus Between Respondent and Petitioners.*

The causation element of a Section 10(b) claim for affirmative misrepresentation does not turn on a connection between the purchaser of the security and the wrongdoer — *i.e.*, a transaction between them — but instead depends on a connection between the wrongdoer's conduct and the purchaser's harm. Accordingly, in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), this Court held that the making of an untrue statement of a material fact and the omission to state a fact that could reasonably be expected to influence an investor's decision to buy or sell creates an affirmative duty to disclose the material fact. *Id.* at 153-54. Here, the damages of both the purchasers of common stock of Beneficial and the purchasers of call options thereon were caused by the same misrepresentations of Petitioners. The statements were not simply directed to the shareholders of Beneficial but were contained in public filings with the SEC, in newspapers, and in press releases transmitted to the investing public in general and, as such, could foreseeably impact, and did impact, the options market as well as the stock market. (Amended Complaint ¶¶25(a),(b), 28(a),(b), 29(a),(b),(c), 31, 34(c), 41-43; Resp.App. 12 to 25) This Court has recognized that the scope of corporate representations reaches a varied audience. *Blue Chip Stamps*, 421 U.S. at 745.

Petitioner's reliance on *Chiarella v. United States*, 445 U.S. 222 (1980) and *Dirks v. SEC*, 463 U.S. 646 (1983) is "entirely misplaced." *Deutschman v. Beneficial*, 841 F.2d at 506 (App. 9a). This Court did not hold in *Chiarella* that a relationship of "trust and confidence" between the plaintiff and the defendant is a prerequisite of every action brought under Section 10(b). What *Chiarella* did hold is that such a relationship is necessary between the parties to insider trading, *i.e.*, where the defendant, while in possession of undisclosed material information, traded in securities at the same time as plaintiff, a fiduciary duty or similar relationship of trust and confidence must be owed by the defendant to the plaintiff to trigger a duty on the part of the defendant to disclose the inside information or to abstain from trading.

Chiarella itself distinguished liability arising from affirmative misrepresentations, like here, and the liability from silence coupled with insider trading, like in *Chiarella*. This Court reasoned as follows:

> At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."

445 U.S. at 227-28. *See also Basic v. Levinson*, 108 S.Ct. at 988, n. 18 (noting difference between duty to "disclose or abstain" in insider trading context and "ever-present duty not to mislead" in the context of affirmative misrepresentations); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969)(while corporation was under no general duty to disclose, any statement the company voluntarily released could not be "so incomplete as to mislead").[9]

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[9] Petitioners' argument that no distinction can or should be made between cases involving non-disclosures and those involving affirmative misrepresentations

(Footnote continued)

Dirks involves the issue of the duty to disclose while in possession of material inside information and thus, like *Chiarella*, bears no relevance to the question presented here relating to the duty to tell the whole truth when one chooses to speak. This Court in *Dirks* merely reaffirmed the holding in *Chiarella* that when one is silent but trades on inside information the disclose or abstain duty is triggered if a relationship of trust exists between the parties. 463 U.S. at 657-58.[10]

The court below correctly interpreted this Court's holdings in *Chiarella* and *Dirks*:

> The district court's reliance on *Chiarella* and *Dirks* is entirely misplaced. Those cases dealt not with injury caused by affirmative misrepresentations which affected the market price of securities, but with the analytically distinct problem of trading on undisclosed information; a theory of recovery which Deutschman does not plead. The "disclose or abstain from trading" rule laid down in the insider trading cases imposes on insiders a duty to disclose information which need not otherwise be disclosed before they act on that information in any uninformed marketplace.
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> * * *

(Petition at 20) ignores the clear distinction made in *Chiarella* and in other cases for the purpose of determining whether plaintiffs should be afforded a presumption of reliance. *Affiliated Ute Citizens*, 406 U.S. at 153 (1972); *du-Pont v. Brady*, 828 F.2d 75 (2d Cir. 1987). *See also Peil v. Speiser*, 806 F.2d 1154, 1161, n.11 (3d Cir. 1986). Furthermore, two independent legal theories for recovery — (1) justifiable reliance on false statements, and (2) failure to speak when under a duty to disclose — are easily differentiated. No court has adopted Petitioners' proposal.

[10] Similarly, *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 35-37 (1977) is inapposite. There, this Court found that the purpose of the Williams Act was to ensure that public investors have adequate information to make an investment decision in connection with a tender offer. This Court refused to extend the protection of the Williams Act to competing bidders for a target company. Here, the Third Circuit, consistent with the purpose of the Exchange Act to protect all investors, properly recognized that the Exchange Act is intended to

(Footnote continued)

> *Chiarella* and *Dirks* involve only the question of when outsiders and nonfiduciaries will be treated as insiders or fiduciaries for purposes of the affirmative duty to disclose or refrain from trading. The court in those cases declined to extend the duty to disclose or abstain to mere tippees who came into possession of otherwise undisclosed information. Nothing in those opinions, however, can be construed to require the existence of a fiduciary relationship between a section 10(b) defendant and the victim of that defendant's affirmative misrepresentation. Except to the extent that other federal statutes may have imposed a disclosure obligation (none are relied on by Deutschman), Beneficial and its officers were free to keep quiet about its business affairs so long as they stayed out of the market. According to Deutschman, however, they chose to speak, and in speaking they were not free to lie. [Citations omitted.]

Deutschman v. Beneficial, 841 F.2d at 506 (App. 9a-10a).

Likewise, "[n]o Supreme Court case and no Court of Appeals case has ever imposed a transactional nexus requirement in a section 10(b) affirmative misrepresentation case." *Id.* at 507 (App. 11a).[11]

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equally protect purchasers of common stock and purchasers of options to acquire that common stock from affirmative misrepresentation which adversely impact the market price of both the options and the underlying stock. *Texas Gulf Sulphur*, 401 F.2d 833, also relied upon by Petitioners, indeed supports Respondent's position. In that case the Court made clear that "4. . . the speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative investors." *Id.* at 849. The fact that *Texas Gulf Sulphur* involved the purchase of the corporation's securities does not mean that purchasers of call options on Texas Gulf Sulpher stock would have lacked standing. In fact, those defendants in *Texas Gulf Sulphur* who purchased calls were found to have violated Rule 10b-5.

[11] Petitioners' citation of *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979) for the proposition that tort principles alone cannot justify implication of a private right of action makes clear Petitioners' misunderstanding of the analysis of the Third Circuit. Statutory construction formed the basis of the decision. *Deutschman v. Beneficial*, 841 F.2d at 505-506 (App. 6a-9a). The discussion by that Court

(Footnote continued)

Indeed, this Court has specifically rejected the notion of privity, or in Petitioner's words, a "transactional nexus," as a prerequisite to a cause of action under Section 10(b) for affirmative misrepresentations:

> "In today's universe of transactions governed by the 1934 Act, privity of dealing or even personal contact between potential defendant and potential plaintiff is the exception and not the rule. The stock of issuers is listed on financial exchanges utilized by tens of millions of investors, and corporate representations reach a potential audience, encompassing not only the diligent few who peruse filed corporate reports or the sizable number of subscribers to financial journals, but the readership of the Nation's daily newspapers. Obviously neither the fact that issuers or other potential defendants under Rule 10b-5 reach a large number of potential investors, or the fact that they are required by law to make their disclosures conform to certain standards, should in any way absolve them from liability for misconduct which is proscribed by Rule 10b-5." (Emphasis added.)

Blue Chip Stamps, 421 U.S. at 745. *See also Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 239 (2d Cir. 1974)(specifically rejecting the argument that a Rule 10b-5 claim for relief must include a "direct transaction [] between plaintiffs and defendants.")

An underlying rationale for the decision of the Third Circuit is that because the market value of an option contract is responsive to changes in the market value of the underlying stock,

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of the tort theory of proximate cause is to rebut the District Court's reliance on *Chiarella*, *Dirks* and other silence cases. In any event, the existence of an implied right of action under Section 10(b) and Rule 10b-5 is no longer open to dispute. *Basic v. Levinson*, 108 S.Ct. at 983; *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13, n.9, (1971); *Affiliated Ute Citizens*, 406 U.S. 128; *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983).

holders of option contracts are susceptible to affirmative misrepresentations which cause the price of the stock to move. This fact satisfies the proximate cause requirement delineated in cases such as *Peil v. Speiser*, 806 F.2d 1154 (3d Cir. 1986). The existence of proximate cause defines the limits of the class to which the wrongdoers are liable. The reasoning of the Third Circuit, in this regard, properly relies on *Blue Chip Stamps*.[12] *See Deutschman v. Beneficial*, 841 F.2d at 507 (App. 11a-12a).

Although the decision of the Third Circuit is not premised upon per se nor does it specifically mention the "fraud on the market" theory, despite Petitioners' claim to the contrary (Petition at 16), the logic of the theory is applicable here. The "fraud on the market" theory, affording a presumption of reliance in Section 10(b) cases, arises out of the recognition that investors rely on the integrity of open and developed securities markets and can thus be defrauded by material misrepresentations which artificially inflate those markets without necessarily relying on the misstatement itself. *See e.g. Basic v. Levinson*, 108 S.Ct. at 988-92. Purchasers of call options rely on the integrity of the market for the call options and the market for the stock upon which the calls are derived. Call option purchasers buy in anticipation of the market price of the stock increasing just as stock purchasers do. In this sense, both call and stock purchasers rely on their "own belief that the market price of the underlying common stock is not reflective of its true value." (Petition at 16). *Basic v. Levinson*, 108 S.Ct. at 991 (" 'it is hard to imagine that there is ever a buyer or seller who does not rely on market integrity. Who

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[12] In *Blue Chip Stamps* this Court held that a company who pursuant to an antitrust decree acquired a right to purchase units consisting of shares of the defendant corporation's common stock and debentures, but who did not exercise the right because of a misleadingly pessimistic prospectus disseminated by the corporate defendant, was not a "purchaser" within the meaning of Section 10(b) of the Exchange Act. The holding was based on the reluctance to extend protection to "bystanders to the securities marketing process" who have not dealt in the security to which the representation or omission relates and who would necessarily have difficulty proving they decided *not* to purchase the security. 421 U.S. at 747. Otherwise, according to this Court, "the door will be open to recovery of substantial damages on the part of one who offers only his own testimony to prove that he ever consulted a prospectus of the issuer, that he

(Footnote continued)

would knowingly role the dice in a crooked crap game?' ") (Citation omitted).[13]

C. *The Holding of the Court of Appeals for the Eighth Circuit in* Laventhall *Involving Insider Trading Does Not Conflict With the Decision Below of the Court of Appeals for the Third Circuit.*

The facts of *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983) are "quite distinguishable" from those presented here. *Deutschman v. Beneficial*, 841 F.2d at 506 (App. 10a).

The plaintiff in *Laventhall* was a seller of option contracts on General Dynamics stock at a time General Dynamics was buying common stock in the open market without disclosing its intention to declare a cash dividend. There was no disclosure by General Dynamics of the intent to declare a dividend; the company was silent on the subject. Thus, the issue in *Laventhall* was whether the company in purchasing its own stock had a duty to a seller of calls to disclose its intention to declare a dividend on its common stock. The Court of Appeals for the Eighth Circuit held no such duty was owed because it failed to find a "transactional nexus between *defendant's trading* in its own stock and *plaintiff's loss*" resulting from plaintiff's sale of options on the stock of General Dynamics, without knowledge of the dividend declaration. 704 F.2d at 412.

The essential causal link between the defendant's fraud and the plaintiff's loss was missing in *Laventhall*, because assuming General Dynamics had not purchased its securities, the plaintiff

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paid any attention to it, or that the representations contained in it damaged him." *Id.* at 746. In contrast, like here, where one purchases securities at an artificially inflated price as a result of another's affirmative misrepresentation, and suffers a loss when the truth is ultimately disclosed, proof of purchase and loss are capable of documentary verification and there is no danger of promoting vexatious litigation by an indeterminate group of persons. *Id.*

[13] In *Zlotnick v. TIE Communications*, 836 F.2d 818, 822-23 (3d Cir. 1988), cited by Petitioners, the Third Circuit would not employ the presumption that

(Footnote continued)

would still have sold his options at the same loss without knowledge of the dividend declaration. In an insider trading case like *Laventhall*, damages are measured by the ill-gotten gains derived from those with whom the insider trades, in that case the shareholders of General Dynamics. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 172-73 (2d Cir. 1980).

In contrast, the causation element of a Rule 10b-5 cause of action is met here because had Petitioners not made the material affirmative misrepresentations complained of, the price of Beneficial common stock and thus the price of call options thereon would not have been artificially inflated, and Respondent would not have suffered the loss that he did when the true facts were belatedly disclosed. Here, there is a direct causal relationship between Petitioners' wrongful conduct and Respondent's damages.

The language of *Laventhall* regarding the lack of a "transactional nexus" in that case must be restricted to cases arising out of analogous facts, namely silence cases involving the trading by defendants in the stock of the subject corporation. Thus, the fact that Petitioners did not trade options on Beneficial common stock is irrelevant.

Similarly, when the Court in *Laventhall* held that the plaintiff in an insider trading case must have a "special relationship" consisting of "trust and confidence" with the defendant, the Court was simply applying judicial precedent developed in the unique context of insider trading liability to an insider trading case. *Laventhall*, 704 F.2d at 412-13, quoting *Chiarella*. As explained in *Chiarella*, the relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with

the market price of the stock reflected all available information when a short seller made covering purchases believing that the market price of the stock was overvalued. In that case, although holding that a short seller has standing under Section 10(b), the Third Circuit found that the short seller, unlike Respondent, did not offer any empirical evidence on the nature of short sales to demonstrate why the presumption makes sense for short sellers as well as common stock purchasers. *Id.* at 822-823, n.7. Significantly, the Third Circuit here did not cite *Zlotnick* in its decision at bar.

the corporation gives rise to a duty to disclose, when no prior statement has been made, because of the necessity of preventing a corporate insider from taking unfair advantage of the uninformed stockholders. *Chiarella*, 445 U.S. at 228-231. However, as heretofore discussed, the legal effect of silence involves considerations far different from those arising from an affirmative act of misrepresentation which is fraudulent, irrespective of the existence of a relationship of trust. *Id.* at 228. Thus, according to the limited holding in *Laventhall*, an option purchaser lacks standing to assert a claim against the common stock issuer if the claim is based on breach of fiduciary duty.

Moreover, as found by the Third Circuit, "[t]he reasoning of the *Laventhall* case with respect to insider trading liability has been tellingly criticized." *Deutschman v. Beneficial*, 841 F.2d at 507 citing Note, *Private Causes of Action for Option Investors under SEC Rule 10b-5 . . .", supra*. The criticism was not further addressed by the Court, however, because, "like the *Chiarella* and *Dirks* holdings, [*Laventhall*] is simply not relevant to the distinct issue of affirmative misrepresentations affecting a market in securities." *Deutschman v. Beneficial*, 841 F.2d at 507 (App. 11a).[14]

[14] Although the existence of conflicts among District Courts is generally not a ground for granting certiorari, all but one of the decisions of the District Courts dealing with the precise question presented, afford option purchasers standing under Section 10(b). *See e.g. In re Digital Equipment Corp. Securities Litigation*, 601 F.Supp. 311 (D. Mass. 1984); *Backman v. Polaroid Corp.*, 540 F.Supp. 667 (D. Mass. 1982); *O'Connor & Associates v. Dean Witter Reynolds, Inc.*, 529 F.Supp. 1179 (S.D.N.Y. 1981); *Lloyd v. Industrial Bio-Test Laboratories, Inc.*, 454 F.Supp. 807 (S.D.N.Y. 1978). Respondent respectfully submits that *Bianco v. Texas Instruments, Inc.*, 627 F.Supp. 154 (N.D. Ill. 1985) is wrongly decided.

In re McDonnell Douglas Corp. Securities Litigation, 567 F. Supp. 126 (E.D. Mo. 1983), like *Laventhall*, applies to allegations of trading without disclosing material inside information as well as to allegations of non-disclosure not involving affirmative misrepresentations, neither of which is applicable to the instant case. The Court in *Data Controls North, Inc. v. Financial Corp. of America*, ____ F.Supp. ____, 1988 U.S. Dist. LEXIS 4602 (D.Md. 1988), on a summary judgment motion, found no evidence of affirmative misrepresentations. In *Tolan v. Computervision Corp.*, C.A. No. 85-1396-N (D. Mass. December 8, 1987) the Magistrate, in his Report and Recommendation, found it "far from clear" whether the case was primarily one of affirmative misrepresentation or non-disclosure. In any event, the Magistrate followed the decision of

(Footnote continued)

II

POLICY CONSIDERATIONS DICTATE DENIAL OF THE PETITION

The Court of Appeals for the Third Circuit rejected the argument that purchasers of call options are entitled to less protection under the Exchange Act for three reasons: (1) the precise class for whose protection the Exchange Act was enacted is participants in the securities markets, of which purchasers of options are members;[15] (2) option contracts permit traders in common stock to engage in hedging transactions which are used to reduce exposure to market fluctuations and are thus risk reducing;[16] and (3) the soundness of the policy judgment leading to the creation of exchanges for option contracts and their treatment as securities is for Congress, the SEC, the Board of Governors of the Federal Reserve System and the Commodities Futures Trading Commission, not for the courts.[17]

Determining that call options are securities to be protected by the Exchange Act is consistent with the policy of that act as originally enacted. Restoring investor confidence in the securities

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the District Court in *Deutschman v. Beneficial* prior to reversal by the Third Circuit.

In *Starkman v. Warner Communications, Inc.*, 671 F.Supp. 297 (S.D.N.Y. 1987), the issue presented was "whether corporate insiders who fail to disclose material inside information and who sell shares in the corporation may be held liable under the anti-fraud provisions of the federal securities laws to persons who trade in options to purchase the corporation's securities," *id.* at 301, thus implying that *Starkman* is analogous to *Laventhall* and *McDonnell Douglas*. However, further in the opinion, during a discussion of issues not relevant here, Judge Walker refers to alleged material misrepresentations as well as omissions.

[15] *Deutschman v. Beneficial*, 841 F.2d at 507, *citing Blue Chip Stamps*, 421 U.S. 723 (App. 11a).

[16] *Deutschman v. Beneficial*, 841 F.2d at 507 (App. 12a).

[17] *Id.* (App. 13a).

markets was a primary reason for adopting the federal securities laws. *See* 1A Bromberg & Lowenfels, *Securities Fraud and Commodities Fraud*, §2.2(110) at 2:13 (October 1979) ("[Statutory antifraud provisions] were part of the initial New Deal response to the financial debacle of the 1920's, investigations of which revealed widespread fraud, manipulation and victimization of public investors by concealment of relevant information"). With respect to Section 10(b) and Rule 10b-5, courts have held that "[t]he statute and rule are designed to foster an expectation that securities markets are free from fraud — an expectation on which purchasers should be able to rely." *Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975). *See also, Lipton v. Documation*, 734 F.2d 740, 748 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985).

The Exchange Act requires Beneficial to file truthful reports with the SEC. 15 U.S.C. §§ 78l and 78m. These filings are typically analyzed by market professionals who formulate recommendations based upon the SEC filings. In turn, stock brokers rely on the analysts' reports in recommending particular securities to their customers. Overstated earnings and assets, like here,[18] will lead to a consistently rising securities price. This brings all kinds of benefits to management, including profits on stock holdings and options, public financings, and increased salaries and bonuses.

Petitioners contend that "options traders contribute nothing to the corporation" and thus should have no standing to seek damages against that corporation, notwithstanding the damage caused by it in the marketplace. This contention must be extended to its logical conclusion. If such a contribution is a requirement of a Section 10(b) action, then all purchasers of Beneficial common stock on the open market, who also contribute nothing to the corporation, must also be denied standing. Only purchasers of common stock in connection with a public offering contribute any capital to the corporation. Consideration paid by purchasers of common stock in the open market does not inure to the corporate issuer of the stock. *See also* pages 9-10, *supra*.

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[18] *See* Amended Complaint ¶¶25(a)(b) and 29(a)(b)(c); Resp. App. 12-17. *See also* note 8, *supra*.

In addition, listed options improve the liquidity of the stock market;[19] increase the trading volume of the underlying shares;[20] and by expanding the range of investment opportunities in the securities markets, encourage more individuals to invest and thus actually foster capital formation.[21]

Petitioners' argument that the result of the Third Circuit gives "a kind of blank check to the creators of securities, with the corporation ultimately acting as the banker" (Petition at 25) is equally faulty. As this Court has made clear, "[o]bviously neither the fact that issuers or other potential defendants under Rule 10b-5 reach a large number of potential investors . . . should in any way absolve them from liability for misconduct which is proscribed by Rule 10b-5." *Blue Chip Stamps*, 421 U.S. at 745. The Third Circuit's decision does not make the corporations "fair game," in the words of Petitioners. (Petition at 27). To the contrary, the decision is consistent with the intended deterrent effect of the federal securities laws. *See e.g., J.I. Case Co. v. Borak*, 377 U.S. 426, 432-33 (1964); *Fridrich v. Bradford*, 542 F.2d 307, 324-25 n. 6 (1976) (Celebrezze, J., concurring), *cert. denied*, 429 U.S. 1053 (1977).[22]

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[19] *See* Johnson, *Is it Better to Go Naked on the Street? A Primer on the Options Market, supra* at 24-26; Rubinstein, *An Economic Evaluation of Organized Options Markets, supra* at 55; Hayes and Tennenbaum, *The Impact of Listed Options on the Underlying Shares*, Financial Management (Winter 1979).

[20] *See* Hayes and Tennenbaum, *The Impact of Listed Options on the Underlying Shares, supra.*

[21] *See* Note, *Private Causes of Action for Option Investors Under SEC Rule 10b-5 . . ., supra*, at 1965; Rubinstein, *An Economic Evaluation of Organized Options Markets, supra*; *SEC Act Release No. 34-22026*, 33 SEC Docket No. 1, 18 at 24 (May 8, 1985).

[22] *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931) (Cardozo, C.J.), relied on by Petitioners (Petition at 26), does not support the proposition that an action for fraud is unavailable to option purchasers, who just like stock purchasers, foreseeably rely on corporate representations which similarly affect the markets for their investments. In fact, in restricting the scope of recovery for negligence, the New York Court of Appeals specifically preserved standing to seek damages for fraud to all those who justifiably rely on one's misconduct.

The analogy by Petitioners of call option contracts to other derivative securities, such as index options, in this context, is made to give a misleading impression of the scope of the Third Circuit's opinion.[23]

Nevertheless, the purported policy considerations advanced by Petitioners are not for the courts to weigh. As the Third Circuit found:

> [I]t is not our role as a court to pass judgment on the soundness of the legislative policy judgments which led to the creation of exchanges for option contracts, and their treatment as securities. Congress, the Securities and Exchange Commission, the Board of Governors of the Federal Reserve System, and the Commodities Futures Trading Commission all have had a role in the evolution of the market for these securities, and the policy judgment was their responsibility, not ours.

Deutschman v. Beneficial, 841 F.2d at 507 (App. 12a-13a). *See also Basic v. Levinson*, 108 S.Ct. at 987, n. 17 ("Perhaps more importantly, we think that creating an exception to a regulatory scheme founded on a prodisclosure legislative philosophy, because complying with the regulation might be 'bad for business', is a role for Congress, not this Court").

[23] Petitioners fail to draw the distinction between calls and index options in stating that in 1987 more than $110 billion in options and index options based on the common stocks of major corporations were traded in the United States. (Petition at 3).

CONCLUSION

For the reasons set forth above, the Petition for Writ of Certiorari should be denied.

Dated: August 4, 1988

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APPENDIX

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

ROBERT M. DEUTSCHMAN,	)	Civil Action No.
	)	86-595 (MMS)
Plaintiff,	)	
	)	
vs.	)	AMENDED COMPLAINT
	)	
	)	
BENEFICIAL CORPORATION,	)	Class Action
FINN M. W. CASPERSEN,	)	
and ANDREW C. HALVORSEN,	)	
	)	
Defendants.	)	

Plaintiff, for his Amended Complaint, which amends the Complaint filed in this action on December 22, 1986, alleges upon information and belief (based on, *inter alia*, the investigation made by and through his attorneys), except as to those allegations which pertain to the securities transactions of the plaintiff, as follows:

NATURE OF THE CASE

1. This is a securities class action on behalf of all persons, other than defendants and affiliated persons as defined in paragraph 15 below, who purchased the common stock of Beneficial Corporation ("Beneficial" or the "Company") or purchased call option contracts thereon, during the period August 21, 1986 through February 27, 1987 (the "Class Period"), seeking to pursue remedies under the federal securities laws and a pendent state law claim. In 1986, including during the Class Period, Beneficial and certain of its officers issued a series of public statements, including reports to shareholders and press releases, regarding Beneficial, its business, and its finances, including the business of and reserves for losses in its insurance division, which statements were materially false and misleading. These actions operated to artificially inflate the market price of Beneficial common stock and of call option contracts thereon during the Class Period, causing

the common stock to rise some $25 to $28 per share. When material adverse facts were revealed these revelations caused Beneficial stock to decline materially, inflicting damage on plaintiff and the class of securities purchasers on whose behalf plaintiff sues herein.

JURISDICTION AND VENUE

2. Jurisdiction and venue of this Court are founded on Section 27 of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. §77aa, 28 U.S.C. §1331, and principles of pendent jurisdiction.

3. The claims herein arise under Sections 10(b) and 20(a) of the Exchange Act, 15 U.S.C. §§78j(b), 78t(a), and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission (the "SEC").

4. Beneficial's corporate headquarters are located at the Beneficial Building, 1100 Carr Road, Wilmington, Delaware. Many of the acts herein complained of, including the preparation, issuance and dissemination of false and misleading material information relating to Beneficial to the investing public, occurred in and from this District. In addition, each of the individual defendants transacts business in this judicial district.

5. In connection with the acts and conduct complained of, as alleged in this Complaint, the defendants used the means and instrumentalities of interstate commerce, including the United States mails and interstate telephone communications, and the facilities of the national securities markets.

THE PARTIES

6. Plaintiff, a resident of the State of California, purchased the following call option contracts using the facilities of a national securities exchange:

Purchase Date	Number of Contracts	Period & Option Price	Contract Price	Cost
11/25/86	40	Jan. 1987 at $70	$2.75/$3	$11,880
12/12/86	15	Jan. 1987 at $70	$1.50	2,349
				$14,229

On Tuesday, December 16, 1986, these contracts had lost some 99.8% of their value and were selling at less than $.50 per contract. On January 12th, just prior to the expiration of these options, they had lost substantially all of their value.

7. (a) Beneficial represents and holds itself out as one of the world's leading consumer financial services companies, concentrating on consumer credit, banking, and insurance. Consumer credit is represented to be the cornerstone of Beneficial's business and the basis of the Company's market franchise. Credit products are provided to consumers through 943 offices in the United States and 175 offices located in Canada, the United Kingdom and West Germany. The Beneficial Insurance Group of the Company provides consumer life, annuity, accident and health, and property and casualty insurance coverages, through Beneficial's credit and banking subsidiaries, unaffiliated financial institutions, automobile dealers, and through direct mail and telemarketing. Beneficial represents that its goal is to achieve superior profits by expanding its financial services franchise, and meeting consumers' needs with quality credit, deposit, and insurance products.

(b) Commencing in or about 1977, Beneficial had entered into the reinsurance insurance business. In reinsurance, the risk of loss insured against is broken up and spread among several carriers; reinsurers share claims in exchange for premiums on policies written by other insurance carriers. The possibility for profits were viewed as favorable because companies in the business could collect premiums and invest them at high rates

of return, without having to pay claims for years. Reinsurance policies in the industry were considered favorable because of the long period of time before claims are paid. Beneficial's reinsurance business was conducted principally through its subsidiary American Centennial Insurance Co. ("American Centennial").

(c) On March 3, 1987, Beneficial announced it was selling American Centennial and certain of its other insurance subsidiaries to members of its management for $10 million cash plus promissory notes with a face value of $98 million. Beneficial represented that it was assigning a "particularly conservative" value to these notes for accounting purposes "in light of the uncertainties inherent in the property and casualty insurance industry." The Company did not disclose what the actual value of the notes would be but the press reported that a Company spokesman described the actual value as "very nominal." Beneficial said also that repayment of the notes would be tied to performance and future value of American Centennial. The proposed sale is subject to regulatory approval and execution of a definitive agreement. When consummated, the sale is intended to remove Beneficial from the property and casualty reinsurance business.

(d) As of March 3, 1986, Beneficial had 22,235,591 shares of common stock issued and outstanding and had a substantially similar number of shares outstanding during the class period, hereinafter defined; its shares were listed for trading on the New York Stock Exchange ("NYSE") as well as other national securities exchanges.

(e) Beneficial call option contracts are traded on the Pacific Stock Exchange. Between September 1st and December 15, 1986 alone more than 55,000 option contracts traded, including some 6,800 January contracts enabling the purchaser of each call contract to purchase 100 shares of Beneficial at either $70 or $75 per share by mid-January, 1987.

8. (a) At all relevant times, defendant Finn M.W. Caspersen ("Caspersen") was and presently is Chairman of the Board of

Directors, Chief Executive Officer, Chairman of the Executive Committee of Beneficial, a member of the Company's Committee on Strategic Planning and Evaluation, and a member of the Company's Finance Committee. Caspersen was first elected a director in 1975. For calendar year 1985, Caspersen was paid by the Company cash compensation of $837,950, in addition to being the recipient and beneficiary of other compensation, fringe benefits, and emoluments in the form of pension plan, savings plan, stock purchase plan, and stock option plan benefits.

(b) As of February 1, 1986, Caspersen and members of his family were the beneficial owners of 832,369 shares of Beneficial common stock, which shares were owned by him, by his spouse or by family trusts and were continued to be owned throughout 1986. In addition, Caspersen is a principal trustee of the Hodson Trust, a charitable trust which owns approximately 1.6 million common shares of Beneficial, or 7% of its outstanding common stock. As one of the principal trustees, Caspersen shares the voting and investment power of such shares.

9. (a) At all relevant times, defendant Andrew C. Halvorsen ("Halvorsen") was and presently is a director, a member of the Office of President, a First Vice President and Chief Financial Officer, Chairman of the Finance Committee, and a member of the Company's Executive Committee and its Strategic Planning and Evaluation Committee. Halvorsen was first elected a director in 1984. For calendar year 1985, Halvorsen was paid cash compensation of $355,900 and in addition received other substantial compensation, fringe benefits and emoluments in the form of pension plan, savings plan, stock purchase plan, and stock option plan benefits. As Chief Financial Officer he shared the responsibility with defendant Caspersen for the accuracy of the financial and textual contents of the Company's financial reports and press releases, including the Company's annual and interim reports to shareholders.

(b) Defendant Halvorsen was a Second Vice Chairman of the Board of Directors of the Company in 1984 and 1985, a Senior

Vice President - Finance from 1982 through 1984, the Assistant to the Chairman of the Board of Directors during the years 1978 to 1981, and in 1981 and 1982 he was a Senior Vice President and Chief Investment Officer of the Company's insurance group of subsidiaries.

10. (a) The Company's Board Committee on Strategic Planning and Evaluation is responsible for undertaking such studies and evaluations as it shall deem necessary for the then current corporate strategy and the social, political and economic environment within which the Company exists and for recommending to the Board of Directors such changes in the function and composition of the Board, including new or additional members, as will best equip the Board to fulfill its duties. That committee met four times in 1985 and to date has met in excess of four times in 1986.

(b) The Company's Board Finance Committee, which met approximately 20 times in 1985 and has met approximately 15 times in 1986, has the responsibility, between meetings of the Board of Directors, to exercise all powers of the Board of Directors with respect to financing the operations of the Company.

(c) The Company's Executive Committee has the authority to exercise substantially all the authority of the Board of Directors (other than such powers which the Board has specifically delegated to other committees) during the intervals between the meetings of the Board of Directors. In 1985, the Executive Committee held approximately 20 meetings and has held a similar number of meetings in 1986.

11. Each of the defendants herein knew or recklessly disregarded the fact that the acts and practices, misleading statements and omissions particularized herein would adversely affect the integrity of the market for Beneficial common stock and call option contracts and artificially inflate or maintain the prices of such securities.

12. Each of the individual defendants is liable as a direct participant in, or an aider and abettor of, the commission of the

wrongs complained of herein. The individual defendants, because of their positions of control and authority as executive officers and/or directors of the Company, were able to and did control the content of the various financial reports, statements and press releases of the Company. As officers and/or directors of a publicly-held company, the individual defendants had a duty to promptly disseminate accurate and truthful information with respect to the Company's operations, financial condition, loss reserves, earnings, and future business prospects so that the market price of the Company's common stock would be based on truthful and accurate information.

13. The individual defendants, by reason of their management positions and/or their membership on Beneficial's Board of Directors, approved the Company's reports for filing with the SEC and the reports and releases for public dissemination and in several instances "signed off" on same, and were, during the time they held said positions at Beneficial, controlling persons of Beneficial within the meaning of Section 20 of the Exchange Act and had the power to control and influence, and did control and influence and cause Beneficial to engage in the practices complained of herein. In addition, each of said defendants acted as agent for one another and for Beneficial and so acted in their respective capacities as officers and/or directors of Beneficial.

14. *Aiding and Abetting.* Each of the individual defendants herein aided and abetted and rendered substantial assistance in the accomplishment of the acts complained of herein. In taking the actions, as particularized herein, to aid and abet and substantially assist the commission of these acts, each defendant acted with an awareness of the primary wrongdoing and realized that his conduct would substantially assist the accomplishment of the acts of gross recklessness and negligent misrepresentation herein complained of.

CLASS ACTION ALLEGATIONS

15. The named plaintiff brings this action as a class action pursuant to Federal Rules of Civil Procedure 23(a) and (b)(3)

on behalf of a class ("the Class") consisting of all persons who purchased the common stock of Beneficial during the period August 21, 1986 through February 27, 1987, or purchased call option contracts thereon during that period, and have or will sustain losses as a result. Excluded from the Class are the defendants herein, members of the immediate family of each of the individual defendants, any entity in which any of the defendants has a controlling interest, and the legal representatives, heirs, successors or assigns of any of the defendants.

16. Because more than 36,000,000 shares were purchased during the Class Period at prices between $78-5/8 and $52-1/4 per share and more than 50,000 option contracts of Beneficial's common stock were purchased in the open market by numerous public investors geographically scattered throughout the United States during the Class Period, the members of the Class are so numerous that joinder of all members is impracticable. While the exact number of class members is unknown to the plaintiff at this time and can only be ascertained through appropriate discovery, plaintiff believes there are more than 2,000 members of the Class. Record owners and members of the Class may be identified from records maintained by Beneficial and/or its transfer agent, from the records of the National Securities Clearing Corporation, the Pacific Stock Exchange, and through broker-dealers who executed trades, and class members may be notified of the pendency of this action by mail, using the procedures and form of notice similar to that customarily used in securities class actions of this nature.

17. Plaintiff's claims are typical of the claims of the members of the Class as plaintiff and all members of the Class sustained damages arising out of defendants' wrongful conduct in violation of federal and state law complained of herein. Plaintiff's claims are typical of the claims of the members of the Class in that they and the class members each purchased shares of common stock of Beneficial during the Class Period and thereby sustained injury as a result.

18. Plaintiff will fairly and adequately protect the interests of the members of the Class and has retained counsel competent and experienced in class and securities litigation.

19. A class action is superior to other available methods for the fair and efficient adjudication of this controversy since joinder of all members is impracticable. Furthermore, as the damages suffered by individual class members may be relatively small, the expense and burden of individual litigation make it impossible for the class members to individually redress the wrongs done to them. There will be no difficulty in the management of this action as a class action.

20. Common questions of law and fact exist as to all members of the Class and predominate over any questions solely affecting individual members of the Class. Among the questions of law and fact common to the Class are:

(a) Whether the federal securities laws and state law of negligent misrepresentation were violated by defendants' acts as alleged herein;

(b) Whether documents, releases, and statements disseminated to the investing public and the shareholders during the Class Period omitted and/or misrepresented material facts about the business and finances of Beneficial;

(c) Whether the defendants acted willfully, recklessly or with gross negligence in omitting to state and/or misrepresenting material facts or in aiding and abetting the making of such misstatements;

(d) Whether the market price of Beneficial common stock and of call option contracts during the Class Period was artificially inflated due to the nondisclosures and/or misrepresentations complained of herein; and

(e) Whether the members of the Class have sustained damages and if so, what is the proper measure of damages.

SUBSTANTIVE FACTS ON WHICH THIS COMPLAINT IS BASED

The Positive Statements Made By Defendants to Portray a New Beginning for Beneficial With the Problems of Its Reinsurance Business Behind It. — "That is It. It's Done."

21. In reporting the results for 1985 in the Annual Report to Shareholders, as to the Beneficial Insurance Group, defendants represented in a letter to shareholders over the signature of defendant Caspersen:

> 1985 was a transitional year for the Beneficial Insurance Group (BIG). Under a new top-management team, supported by realigned and expanded middle-management ranks, the insurance Group made great progress toward mitigating the risk of future loss exposure resulting from our previously-written property and casualty reinsurance business. Concurrently, the BIG management team made major strides in refining and strengthening our powerful consumer credit insurance and annuity businesses. It also began development of other profitable personal line products that will enable the Beneficial Insurance Group to reestablish itself as a highly profitable consumer insurance business, offering a broad line of retail insurance products.

It was further represented at page 25 of that Annual Report:

> Beneficial Insurance Group
>
> 1985 was a year of substantial progress for the Beneficial Insurance Group (BIG). Although net earnings of the Group were only modestly improved to $5.0 million from $1.9 million in 1984, major studies were made toward solving the problems of the Group's property and casualty (P&C) reinsurance operation, which has been such a serious drag on BIG's recent results. BIG's operations were redirected and refocused

during 1985, laying the groundwork for what is anticipated to be a dramatic recovery in Insurance Group profitability over the next several years.

BIG's principal business segments — credit insurance and annuities — continue to be quite profitable. BIG's total premium revenue rose 26% to $711.3 million in 1985 from the prior year's $565.1 million, led by increases in annuity writings and credit insurance. *The reinsurance results, however, continue to offset the Group's otherwise excellent performance. The losses that emerge from reinsurance reflect the past mistakes of entering the reinsurance market at a point in its business cycle where premiums were insufficient in relation to risks insured, compounded by a business strategy focusing on the utilization of managing general agents (MGA's)* (Emphasis added.)

22. From January 1986 through August 15, 1986, the common stock of Beneficial traded between $45 and $54.50 per share. In the six weeks preceding Friday, August 22, 1986, the high, low and closing prices were as follows:

Week Ended Friday	High	Low	Close
July 18	$48.00	$45.25	$46.00
July 25	46.75	46.00	46.50
August 1	48.25	46.125	47.125
August 8	47.50	46.00	47.375
August 15	47.625	47.00	47.625
August 22	75.25	44.25	73.00

23. After August 22, 1986 and until December 12, 1986, Beneficial common stock traded between $64.625 per share and $79 per share, closing on December 12th at $65.00, having traded that day as high as $69. From December 16, 1986 to March 3, 1987, the shares traded from $52.25 to $65.25, and at a high of $62 and a low of $61.25.

24. The precipitous rise in the price in late August 1986, from its trading range immediately prior thereto — namely, an increase of some $30 per share — resulted from the Company's announcement of August 21, 1986, principally contained in a letter to shareholders over the signature of defendant Caspersen, described herein at paragraph 25.

25. (a) On August 21, 1986, the following letter was sent to the shareholders of Beneficial over the signature of defendant Caspersen and at the same time was issued by Beneficial in the form of a press release to the national wire services:

> To Our Shareholders:
>
> Over the past several years your management has been implementing a strategic program designed to strengthen our businesses, improve profitability and minimize the values inherent in Beneficial for our stockholders.
>
> As a result of our efforts, the company's financial performance has improved markedly and we are now clearly focused on the businesses we know best — providing a wide range of financial services to consumers. Moreover, we have in place the assets, organization and, most importantly, the people that make Beneficial a leading competitor in the consumer financial services marketplace.
>
> Having achieved the initial objectives of our strategy, we began in the early part of 1986 to plan the next phase. We concluded that there are several available paths which would enable our shareholders to realize the enormous value inherent in the Company. Accordingly, in June, we began consulting with the First Boston Corporation as independent financial advisor to work with us in exploring the full range of possibilities...

Today, your Board of Directors authorized your company's management and First Boston to evaluate thoroughly the full range of tactical and strategic alternatives that would enable us to maximize value for you, our shareholders. These alternatives may include, among other things, the sale of Beneficial, merger or other business combination with another entity, the sale of certain assets, repurchase of debt and equity securities and spin-off or sale of subsidiaries. Obviously, at this point, we cannot predict the outcome of the process nor which, if any, of the alternatives will be recommended. We can, however, assure you of the most comprehensive effort to identify and pursue the most meaningful and profitable course for Beneficial and all of its shareholders. *In this connection, the Board of Directors has authorized employment contracts for certain officers of the company and a value-created incentive cash bonus plan for certain key executives who are, and will be, instrumental in successfully achieving the strategic alternatives which may be implemented by the company. The plan provides for payments equal to an aggregate of 7 percent of the increase in the price of the company's common stock above $70 per share upon the earlier of the sale or major restructuring of the Company or the end of 1987.*

* * *

In order to facilitate whichever strategic course is decided upon, we have determined to anticipate any future adverse loss development in our insurance business by recording a special reserve addition to our property and casualty reinsurance reserves.

While final actuarial, accounting, tax and legal analyses are not yet complete, it appears that a reserve addition of roughly $260 million pretax (approximately $150 million net, after tax benefits) may be booked

before year-end to build claim reserves for anticipated ultimate loss emergence and to cover reinsurance recoverables, both related to the run-off of the Company's terminated book of property and casualty reinsurance. This reserve addition is clearly the proper course of action to deal aggressively and forthrightly with this situation and clear the way for the realization of shareholder value. *In order to be particularly conservative, the reserve addition would include provisions sufficient to bring reserves of our major property and casualty subsidiary to "high prudent" — the upper end of the range of estimates provided by our outside actuaries* (Tillinghast, a division of Towers, Perrin, Forster and Crosby). (Emphasis added.)

(b) The foregoing was reiterated in a Report on Form 8-K filed by Beneficial with the SEC on August 28, 1986, by the inclusion of that letter verbatim, wherein the company reported, *inter alia*:

> The Company has begun to evaluate thoroughly the full range of tactical and strategic alternatives that would maximize shareholder value. These alternatives may include, among other things, the sale of Beneficial, merger or other business combination with another entity, the sale of certain assets, repurchase of debt and equity securities and spin-off or sale of subsidiaries.

The representation was further reiterated at page 7 of the Company's Report on Form 10-Q dated November 12, 1986, for the quarter ended September 30th.

26. The 66% increase in the market price of Beneficial stock resulted from the foregoing August 21st announcement. Value Line's Investment Survey dated September 19, 1986 at page 2058 reported the following with respect to that August 21st announcement:

Wall Street's reaction was enthusiastic. Beneficial shares skyrocketed 66% to $73 on the day after the disclosure. One needn't look hard for the reason: The company is among the leading credit card issuers in the United States, with over $1 billion in receivables, its second-mortgage portfolio ($3.1 billion) is the largest in the nation, and its credit insurance and annuity businesses are very profitable. Moreover, Beneficial's reserve for credit losses is so high that it could safely be reduced to provide funding for greater receivable growth.

A $2.25-a-share writeoff in the September quarter for anticipated future losses is positive. Over the past 18 months, Beneficial's earnings have been plagued by losses from its property/casualty reinsurance business, which was discontinued in 1984. This scuttled segment produced aftertax losses of $58 million prior to this year and $17 million in the first half of 1986. An actuarial reassessment indicated there was potential for more red ink. The charge will result in a huge operating loss for 1986, but it will substantially strengthen the balance sheet.

Value Line concluded that "the earning power of Beneficial's core financial services business can command a share price in the $90-$100 range."

27. Thus, the investment community believed that the August 21st statement clearly was reliable and that management had established a reasonably based and conservatively prudent reserve at the upper end of the range of estimates for losses from its discontinued reinsurance business.

28. (a) A *Wall Street Journal* article of September 2nd, by Laurie Hays, a staff reporter, entitled "Reinsurance Woes Threaten Beneficial" reported:

> Late last month, the financial-services concern announced it will put another $260 million into its reserves for current and future losses. The company expects to post a $50 million loss for the year.

(b) Defendant Caspersen was quoted in this *Wall Street Journal* article, as follows:

> "We got taken to the cleaners . . . . But it's our view that we've put the problem behind us. This is it. It's done."

The representation that the problem was behind the Company — "This is it. It's done" — was materially false and misleading, as hereinafter more particularly alleged at paragraph 48, *infra*.

(c) On September 2, 1986, the closing price of Beneficial common stock was $73. Following Caspersen's statement described herein, the price increased to $74-7/8 on September 3rd, and $75 on September 4th.

29. (a) On October 31, 1986, Beneficial reported its third quarter results for the three months ended September 30, 1986. Beneficial reported a net loss of $126 million or ($5.80) per share compared to reported earnings of $26 million and $.99 per share the prior comparable period ended September 30, 1985. For its Beneficial Insurance Group, Beneficial reported a $160.4 million net loss for the quarter, which reflected a $260 million pretax addition to reinsurance reserves.

(b) The common stock of Beneficial closed at $74.25 per share on October 31, 1986. The $260 million loss reserve as announced had been expected and was consistent with the representations made in the August 21st announcement of Beneficial and the September 2nd representation of Caspersen as contained in the *Wall Street Journal*, that the Company's reinsurance problems were behind it. Accordingly, the market price of Beneficial securities was not impacted adversely.

(c) The foregoing was reiterated in the Report on Form 10-Q filed by Beneficial for the quarter ended September 30, 1986 signed by defendant Halvorsen. Specifically, it was reported in that 10-Q, at page 6:

> Insurance policy and claim reserves increased $620 [million] or 34% during the nine months of 1986 due to additional annuity writings and the recording of additional insurance reserves of $260 [million]. This reserve strengthening was based upon recently completed actuarial studies and is intended to cover anticipated loss emergence and reinsurer insolvencies, both related to the runoff of the Company's terminated book of property and casualty reinsurance.
>
> * * *
>
> . . . The additional reinsurance reserve of $260 recorded during the third quarter of 1986 resulted from intensive internal and external actuarial studies to assess the effect of loss emergence and reinsurance insolvencies in the runoff of the Company's terminated book of property and casualty reinsurance business.

and at page 8 thereof in the notes to the financial statements, the following was reported:

> 3. During the third quarter of 1986, actuarial studies were completed and a $260 special addition to insurance reserves (approximately $150 after-tax) was recorded. This reserve addition was recorded to provide for loss emergence and reinsurer insolvency in the company's terminated property and casualty reinsurance business.

(d) Further, the letter to shareholders over the signature of Caspersen dated November 12, 1986, contained in the interim

report to shareholders for the third quarter 1986, emphasizes the alleged thoroughness used in computing the $260 million increase in insurance reserves, as follows:

> The Beneficial Insurance Group (BIG) reported a $160.4 million loss for the 1986 third quarter compared to prior year earnings of $1.6 million. For the nine months, the Group had a net loss of $152.9 million compared to profits in 1985 of $2.0 million. In September, BIG recorded a $260 million increase in reserves for the property and casualty reinsurance business. This reserve strengthening was a result of in-depth internal and external actuarial reviews which utilized the more complete information now available from the successful migration of BIG's managing general agent records to an in-house system. In addition, the acturial projection takes into consideration the adverse loss development that was experienced since the third quarter of 1985. Additional reinsurance losses of $20 million pretax were recorded to strengthen insolvency reserves relating to insolvency occurrences in 1985 and prior years, that were not covered by the previously executed aggregate excess contract, reflecting the higher reserve levels of the overall reinsurance book of business. As expected, new exposure reinsurance premium writings continue to decline quarterly.

Beneficial as a whole reported losses of $126 million and $68.7 million for the three and nine months ended September 30, 1986, respectively.

30. Analysts perceived, consistent with Caspersen's reported statement in the September 2nd *Wall Street Journal* article, that

Beneficial's problems with its reinsurance business were behind it. As reported in *Value Line* on page 2056 of its Investment Survey dated December 19, 1986:

> *We think Beneficial has put a long-standing problem behind it, for a price.* Even after the company withdrew from the troubled property/casualty (P/C) reinsurance business in 1984, claims arising from when its policies were in force necessitated sizable loss reserve problems. A recent actuarial reassessment indicated that more of the same was in prospect so Beneficial moved quickly to plug the dam. The company wrote off $260 million (about $150 million after-tax) as a special addition to insurance reserves. To be sure, this will produce a huge operating loss for 1986, but we think management is making the right move. This charge is more than three times greater than the cumulative P/C losses Beneficial has experienced to date, *and almost certainly eliminates the need for further P/C reserve strengthening for several years. Consequently, this scuttled line, in our view, will no longer burden Beneficial's earnings.* [Emphasis added.]

31. At no time, commencing with the August 21st press release, was there any disclosure of the Company's intentions to take a write down resulting from the discontinuance of its property and casualty reinsurance business or a write down as a result of a sale thereof or of the need to restate previously reported financial statements to reflect such a write down. To the contrary, the problem had been represented as having been behind the Company.

The February and March 1987 Disclosures

32. In an article appearing in the February 26, 1987 issue of the *Wall Street Journal*, of Laurie Hays entitled "Beneficial

is Expected to Post 1986 Loss Far Wider Than $50 Million Forecast," it was reported that Beneficial's losses for 1986 would "far exceed [ ] the $50 million loss company officials previously anticipated" as reported in the *Wall Street Journal* of September 2, 1986, and attributed to Caspersen in the *Wall Street Journal* of December 16, 1986. The article reported that analysts estimated the Company would post a loss between $80 million and $112 million.

33. On February 26, 1987 Beneficial announced in a press release:

> "Beneficial Corporation today reported a net loss of $171.6 million for 1986 compared to net income of $101.2 million in 1985.
>
> While 1986 income from continuing operations increased 20 percent to $88.1 million from $73.3 million in 1985, a $279.1 million net loss from discontinued operations was incurred relating to the company's previously announced restructuring plan. The restructuring involves the sale of the company's bank credit bank subsidiary, most of the companies making up the Beneficial Insurance Group. . . .
>
> The $279.1 million net loss from discontinued operations is comprised of $147.3 million in net losses from operations discontinued in 1986, which reflects the massive losses of Beneficial's discontinued property and casualty insurance subsidiaries, and a $131.8 million estimated loss on disposal of discontinued business."

34. (a) On or about February 27, 1987, the *Wall Street Journal*, in an article entitled "Beneficial Posts Loss for 1986 of

$171.6 Million," stated that Beneficial reported a 1986 loss of $171.6 million, primarily due to heavy reinsurance losses and a write down for the sale of the insurance unit, that this loss included a loss from discontinued operations of $279.1 million, and that Beneficial's reinsurance operation contributed significantly to the loss. The previous three quarters of fiscal 1986 were reportedly restated to reflect the discontinued operations.

(b) The February 27th *Wall Street Journal* article further reported with respect to statements of defendant Halvorsen:

> Andrew C. Halvorsen, chief financial officer, said Beneficial's ailing reinsurance unit, American Centennial Insurance Co., contributed "significantly" to the loss. *Beneficial in the fourth quarter pumped additional funds into reserves for the unit, beyond the $260 million added to reserves in the third quarter, Mr. Halvorsen said.*
>
> He declined to specify the amount of the additional reserves, but said they are included in the $279.1 million loss from discontinued operations. Beneficial took a charge of $150 million for the third-quarter addition to reserves.
>
> "There's no need to disclose the breakdown of the provision," Mr. Halvorsen said. He said the reserves were added to prepare the unit for a sale currently under negotiation. He declined to say who the buyer was or whether the state of Delaware's Department of Insurance had approved such a sale. [Emphasis added.]

This belated admission by defendant Halvorsen confirms the accuracy of the assertions in the *Wall Street Journal* article of December 16, 1986, that further reserve additions in excess of the $260 million provided in the third quarter would be required.

(c) Despite denials from Beneficial's management in mid-December 1986, hereinafter alleged and as reported in the *Newark Star Ledger* of December 17th, that further additions to the insurance reserves would be needed, such additions were in fact made in the fourth quarter, and acknowledged by Halvorsen in the *Wall Street Journal* article of February 27th.

The Attempts to Sell Beneficial and the Cover-up of Continuing Problems in Beneficial's Insurance Division After September 2nd.

35. Prior to August 21st, Beneficial's investment banker, First Boston Corp., is reported to have advised the Board of Directors of Beneficial that it could add value to the stock price by selling Beneficial by the end of 1986.

36. As an incentive to the individual defendants and particularly Caspersen, a bonus for increasing the price of the Company's common stock above $70.00 per share was promised. Thus, in addition to the substantial personal gain to be realized from a sale of his and his family's approximately 830,000 shares and the gain to the Hodson Trust from a sale of its 7% interest, Caspersen had an incentive to maximize the market price of the Company's publicly traded securities, while at the same time minimizing the magnitude of the reinsurance business losses being sustained by Beneficial.

37. In September, 1986, it was announced that management of Beneficial was asking $100 per share for the Company.

38. On November 20, 1986 the Company announced:

> It has called a special meeting of shareholders for December 23 to consider a plan of liquidation.

> The Company said it wants to take advantage of benefits available under the tax reform act's transition rules that permit the company to complete such a liquidation in 1987.
>
> Beneficial said it will provide "Maximum flexibility as it reviews and pursues restructuring alternatives."

The Company at the same time declined to disclose whether a buyer had been found for the Company.

39. On Friday, December 12th after 4:00 p.m., the Company announced it had

> canceled the special shareholders meeting that had been scheduled for Dec. 23 to consider a proposed liquidation of the company.
>
> Instead, the company's board will meet Dec. 18 to review what the company called "A variety of strategic alternatives."
>
> The company said the decision to cancel the meeting "doesn't mean that Beneficial is no longer for sale."
>
> It said the meeting was canceled because liquidation is no longer being considered an option by management, but it said liquidation may be reconsidered next year.
>
> Beneficial said the board expects to announce its "conclusions" about the restructuring at its December 18 meeting.
>
> The company said the restructuring alternatives include sale of the company. A merger with another entity, sale of certain assets, repurchase of securities and the spin off or sale of subsidiaries.

40. (a) In a December 16th *Wall Street Journal* article by Laurie Hays, entitled "Beneficial Corp. is Expected to Bolster its $260 Million Reinsurance Reserve," it was reported that the Company is "expected to have to bolster the $260 million reserve set aside in the third quarter for its troubled reinsurance business . . . needed to cover claims that were overlooked in an earlier audit. . . ."

(b) The article further reported the following with respect to statements of defendant Caspersen:

> *"This is it*
>
> We've put the problem behind us," Finn M.W. Caspersen, Beneficial's chairman, said at the time of the change. *"This is it. It's done."*
>
> * * *
>
> As previously reported, Beneficial put itself up for sale in late August when Mr. Caspersen announced the significant and unexpected losses in the company's reinsurance business. At the time, Mr. Caspersen said some of the losses were the result of fraud. *He said also the $150 million charge was expected to result in an earnings loss of $50 million for the year.* [Emphasis added.]

(c) Ann Stephenson, Beneficial's Vice President - Public Affairs, was quoted as follows in the article:

> Beneficial declined to discuss whether the company would take further reserves. "We have and we are taking all action as we deem appropriate with respect to reinsurance," said a spokeswoman.
>
> She said the company is "always reviewing" all accounting relating to the reinsurance reserves.

41. As a result of the disclosure of the foregoing in the *Wall Street Journal* of December 16th, the market price of Beneficial common stock dropped some 20%. On December 16, 1986, the common stock closed at $57-1/8 after trading as low as $54-3/4, having precipitously declined some 20% from its December 12, 1986 closing price of $65.

42. (a) Beneficial responded to the December 16, 1986 *Wall Street Journal* article by falsely or recklessly asserting, through Ann Stephenson, that Beneficial had "no intention to increase our reserves above what was set aside in the third quarter. Outside actuaries have told us that our reserves are currently at the upper end of the range required. We are not conducting any further audits and we don't believe that any are necessary." These remarks were quoted in the *Newark Star Ledger* on December 17, 1986.

(b) On December 16, 1986, the Insurance Commissioner of Delaware was caused to issue a press release claiming that his remarks had been taken "out of context" by the *Wall Street Journal* and that Beneficial "is a respected corporate citizen of the State of Delaware." These comments were also disseminated in the press as a result of a press release, dated December 16, 1986, issued by the State of Delaware Insurance Department.

(c) In substance, Beneficial and the individual defendants had caused a denial of the need for any additional reserves and a denial of any additional financial problems relating to its reinsurance business, which denials were not reasonably based and had to have been known to them to be false.

43. The market price of Beneficial common stock has continued to fall in December, opening on December 19, 1986 at $56, $3 below the close on December 18, 1986, and trading as low as $54.75. Notably, the market price of Beneficial common stock would have plunged even further if defendants had not sought to cover up the difficulties suffered in the Company's reinsurance business.

44. On December 19, 1986, Beneficial announced that the Company's Board of Directors had approved a restructuring plan. The Company's press release as carried over the Dow Jones News Service, stated in pertinent part:

> Beneficial Corp. said its board approved a restructuring plan involving the sale of "significant segments" of certain businesses, in an effort to streamline the company and return it to its basic operation.
>
> The company said proceeds from the sale of the units, which include some insurance business, could exceed $1.4 billion after tax, but before repayment of certain inter-corporate advances. Beneficial said after the repayment the proceeds would be about $750 million.
>
> The company does not have buyers for these businesses and said it will "aggressively pursue" a restructuring involving the sale of the businesses. The businesses to be sold include, Beneficial credit card subsidiary, Western National Life Insurance Co., Beneficial's annuity insurance subsidiary and other companies making up the Beneficial Insurance Group, including the domestic and international property and casualty subsidiaries.
>
> Beneficial said it also would pursue the sale or joint venturing of its investment real estate properties.
>
> Beneficial said selected additional segments of its businesses not related to the core consumer lending operations, also will be under review for possible sale.
>
> The proceeds will be used to reduce short- and long-term debt and to fund growth in the consumer finance

> business, the company said. In addition, a portion of the proceeds is planned to be used for a repurchase of an as yet undetermined amount of Beneficial common stock, in an effort to maintain or improve credit ratings.
>
> As previously reported, Moody's Investors Service Inc. lowered its ratings on all of Beneficial's $4.4 billion of debt in October. The rating concern cited Beneficial's increased loss provisions for property and casualty insurance.

45. Also on December 19, 1986, Beneficial announced that its Board had rejected an offer from a "major U.S. corporation" to acquire all of Beneficial's operations except the Company's reinsurance business. The Company's press release, as carried over the Dow Jones News Service, stated in pertinent part:

> Beneficial Corp. said it decided on the restructuring of its operations despite an offer from a "major U.S. corporation" to acquire all of Beneficial's operations, except those associated with its property and casualty insurance business.
>
> Beneficial said the proposal from the unidentified corporation was for $1.92 billion, or $83 a share in cash, but was subject to "significant conditions" and retention by Beneficial of certain liabilities, in addition to those associated with the insurance business. Beneficial said it learned one day before its directors met that the board of the proposed acquiror hadn't approved the transaction. Beneficial said it then received a new proposal from the same company but the price was reduced to $1.74 billion, or $75 a share.
>
> The new proposal also was subject to the earlier conditions. Beneficial said the board rejected the proposal because the price was "inadequate" and the conditions "unacceptable."

COUNT I

AGAINST ALL DEFENDANTS FOR VIOLATION OF SECTIONS 10(b) AND 20(a), AND RULE 10b-5 OF THE EXCHANGE ACT

46. Plaintiff incorporates paragraphs 1 through 45 as though set forth fully herein.

47. Throughout the Class Period, defendants, singularly and in concert, pursuant to a common course of conduct and using the means and instrumentalities of interstate commerce (including the United States mails), knowingly and/or recklessly (a) employed devices, schemes and artifices to defraud; (b) omitted to state material facts necessary in order to make the statements made in light of the circumstances under which they were made not misleading; and (c) engaged in acts, practices and a common course of business which operated as a fraud or deceit upon plaintiff and the Class as herein alleged and acted as a market manipulation of Beneficial securities. The purpose and effect of said scheme was to (i) conceal all the adverse facts concerning its business and particularly the reinsurance loss reserve; and (ii) to maintain an artificially high market price for the common stock of Beneficial in order to insure a sale of the Company, if it were to be sold, at greater than $70 per share. Particularly, Beneficial aided and abetted by the individual defendants recklessly or deliberately engaged in a "cover-up" of material information relating to its property and casualty reinsurance business.

48. On August 21, 1987, the Company announced the increased reserve for reinsurance losses, and on September 2nd, the *Wall Street Journal* quoted defendant Caspersen as saying, with respect to the losses associated with reinsurance business, "This is it. It's done," and again on December 16th when the *Wall Street Journal* repeated the same quotation of defendant Caspersen, plaintiff and the class reasonably could believe that

whatever problems the Company had had with its reinsurance business, were recognized and evaluated, with an appropriate and sufficient reserve, and the problem put behind it, and that Beneficial was poised for growth and profitability, either through operations or through a sale or restructuring of its business.

49. At no time after December 16, 1986, or following September 2, 1986 did defendants attempt to correct this untrue statement of Caspersen that the problems with the reinsurance business were behind it, nor the misleading impression created by it. Defendants made no effort to disclose on or about December 16th, when the news of a further audit was disclosed, that it would be necessary to or possible that it would have to increase its reserves, and that a materially greater loss than the $50 million expected, as reported by the *Wall Street Journal* on September 2nd and December 16th, would foreseeably result. To the contrary, the defendants made an affirmative effort to dispel the truthfulness of the disclosures in the *Wall Street Journal* article of December 16th that the Company's problems with its reinsurance unit were not behind it and that additional audit work was being undertaken. Moreover, defendants did not correct the misleading impression created by its statements in the fall of 1986 that the audit work associated with the establishment of the $260 million reserve was thorough.

50. The defendants knew, or were reckless in not knowing, that the reserve projections first announced on August 21st and reiterated in September and October were materially understated and such understatement, as well as the disclosure of realistic reserves, would adversely impact a sale of the Company.

51. The August 21st announcement had a further manipulative effect on the market price for Beneficial common stock by creating an artificial floor on the stock's market price by suggesting, without reasonable basis in fact, that $70 was the minimum fair value for the Company's shares.

52. As a result of the material misrepresentations and material omissions and other conduct complained of, which continued throughout the Class Period, securities of the Company were purchased by the plaintiff and other members of the class at artificially inflated prices and in a false market climate crea·ted by defendants.

53. As a result of the defendants' misrepresentations and material omissions complained of, plaintiff and the other members of the class suffered substantial losses on their securities purchased in the Class Period and were damaged thereby.

COUNT II

AGAINST ALL DEFENDANTS UNDER THE COMMON LAW OF NEGLIGENT MISREPRESENTATION

54. Plaintiff incorporates paragraphs 1 through 53 as though fully set forth herein.

55. Among the direct and proximate causes of the misrepresentations and omissions to state material facts set forth above was the negligence and carelessness of the defendants.

56. At the time of said misrepresentations and omissions, plaintiff and other members of the Class were ignorant of their falsity, and believed them to be true. In reliance on said misrepresentations and in reliance upon the superior knowledge and expertise of defendants, and in ignorance of the true facts, plaintiff and other members of the class were induced to and did purchase Beneficial securities. Had plaintiff and other members of the Class known the true facts, they would not have taken such action. By reason thereof, they have been damaged. Said reliance by and damage to the Class was foreseeable to each defendant.

WHEREFORE, plaintiff demands judgment, as follows:

1. Determining this action is a proper class action maintainable pursuant to Rule 23 of the Federal Rules of Civil Procedure;

2. Awarding to plaintiff and the other members of the Class damages from Beneficial and the individual defendants, jointly and severally, together with appropriate interest;

3. Awarding to plaintiff and the other members of the Class relief as may be just and proper under the circumstances; and

4. Awarding to plaintiff and other members of the Class the costs and disbursements of this action, including reasonable fees to plaintiff's attorneys, accountants and experts.

Dated: March 5, 1987

BIGGS & BATTAGLIA

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③

No. 88-36

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

BENEFICIAL CORPORATION, FINN M.W. CASPERSEN,
ANDREW C. HALVORSEN,

Petitioners,

—against—

ROBERT M. DEUTSCHMAN,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITIONERS' REPLY BRIEF

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1988

BENEFICIAL CORPORATION,
FINN M.W. CASPERSEN,
ANDREW C. HALVORSEN,

Petitioners,

-against-

ROBERT M. DEUTSCHMAN,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

PETITIONERS' REPLY BRIEF

Petitioners respectfully submit this short reply to the Brief of Respondent in Opposition to Petition for a Writ of Certiorari ("Resp. Br."). Respondent makes only a few points in opposition to the petition which merit a response.

I

THE DECISION OF THE COURT OF APPEALS CONFLICTS WITH A DECISION OF THE EIGHTH CIRCUIT

In *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983), General Dynamics failed to disclose an impending dividend while purchasing shares of its common stock in the open market. At the same time, Laventhall sold call options and failed to receive the higher price for these options he would have realized had General Dynamics disclosed its dividend plans. The Eighth Circuit dismissed Laventhall's complaint.

Respondent tries to distinguish *Laventhall* by arguing incorrectly that it was decided only on the basis of a lack of causation or injury, whereas here "the causation element of a Rule 10b-5 cause of action is met." Resp. Br. at 18-19. But the Eighth Circuit did not hold that Laventhall was uninjured by General Dynamics. It held that Laventhall lacked standing by reason of his status as an option trader, quoting from Judge Lasker's opinion in *O'Connor & Assoc's v. Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179, 1184 (S.D.N.Y. 1981), that "[t]he relationship between corporate insiders and shareholders stands in stark contrast to the lack of relationship between corporate insiders and options traders." 704 F.2d at 411.

Respondent's attempts to distinguish among an insider trading case, a nondisclosure case and an affirmative misrepresentation case involving a corporate spokes-

man avail him nothing. Resp. Br. at 13-14 and n.9. The only important difference among these cases that Respondent can point to is the difference in circumstances giving rise to the duty to disclose, *e.g.*, the disclose-or-abstain rule in insider trading cases and the "ever-present duty not to mislead" in affirmative misrepresentation cases. *Basic Inc. v. Levinson*, ___ U.S. ___, 108 S. Ct. 978, 988 n.18, 99 L. Ed. 2d 194, 214 n.18 (1988). Resp. Br. at 13-15. But while the duty to speak truthfully can arise from a number of different circumstances, that does nothing to answer the question at the heart of the conflict between *Laventhall* and this case, which is, *once the duty to make truthful disclosure arises, to whom is that duty owed*?

Nothing in Rule 10b-5 nor Section 10(b) distinguishes among those to whom a duty of disclosure is owed based on whether the person with the duty to speak truthfully is an insider trader or a corporate spokesman, or on whether the breach of the duty is occasioned by silence or by speech. Unless such a distinction exists, and neither the Respondent nor the Third Circuit has said why it should, there is a direct conflict between *Laventhall*, holding that an options trader was not owed a duty by a corporation engaged in insider trading, and the opinion below, holding that an options trader was owed a duty by a corporation making a corporate announcement.

It is not surprising, therefore, that the district courts[1] and commentators[2] considering this issue have concluded that the *Laventhall* rationale conflicts with that used by the Third Circuit.

II

RESPONDENT'S OTHER POINTS ARE WITHOUT MERIT

Respondent makes several references to the fact that issue has not been joined and that no proceedings have been held as to class certification, arguing that the question presented by this petition is premature. Resp. Br. at 2, 5 & n.3. His position, of course, is wholly incorrect. A

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1 See *Bianco v. Texas Instruments, Inc.*, 627 F. Supp. 154, 161 (N.D. Ill. 1985) ("We do not agree that the distinction between affirmative misrepresentation and nondisclosure calls for a different rule as to the standing of options traders to sue under § 10(b)."). In *in re Warner Communications Sec. Litig.*, 618 F. Supp. 735, 743 (S.D.N.Y. 1985), *aff'd*, 798 F.2d 35 (2d Cir. 1986), Judge Keenan observed, before the decision below was rendered, that the courts are "split" and that *Laventhall* conflicts with *In re Digital Equip. Corp. Sec. Litig.*, 601 F. Supp. 311 (D. Mass. 1984) ("*Digital*") and *Backman v. Polaroid Corp.*, 540 F. Supp. 667 (D. Mass 1982) ("*Backman*"), both of which reached identical results to that below on similar facts.

2 *E.g.*, Note, *Private Causes of Action for Option Investors Under SEC Rule 10b-5: A Policy, Doctrinal and Economic Analysis*, 100 Harv. L. Rev. 1959, 1960 and n.10 (1987) ("Courts have split, however, as to the standing of option holders to bring private actions against insiders for Rule 10b-5 violations.") (citing *Laventhall*, *Digital*, *Backman*, and similar cases).

plaintiff's standing is a threshold issue which may properly be resolved by this Court on a motion to dismiss prior to an answer to the complaint or any other proceedings. *See Warth v. Selden*, 422 U.S. 490, 498 (1975); *LaDuke v. Nelson*, 762 F.2d 1318, 1325 (9th Cir. 1985) ("Standing . . . is a jurisdictional element which must be satisfied prior to class certification."), *modified on other grounds*, 796 F.2d 309 (9th Cir. 1986); *see also Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979) (limits of implied cause of action under Investment Advisers Act of 1940 tested on motion to dismiss); *Manor Drug Stores v. Blue Chip Stamps*, 339 F. Supp. 35 (C.D. Cal. 1971), *rev'd*, 492 F.2d 136 (9th Cir. 1973), *rev'd*, 421 U.S. 723 (1975).

Next, Respondent states that the "policy considerations advanced by the Petitioners are not for the courts to weigh." Resp. Br. at 24. Respondent is wrong again. Private rights of action under Section 10(b) and Rule 10b-5 are not creatures of statute but of judicial implication. Thus, as this Court stated in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), when interpreting the scope of the private right of action under Rule 10b-5, it is "proper that we consider . . . what may be described as policy considerations." *Id.* at 737; *see also Cannon v. University of Chicago*, 441 U.S. 677, 689, 709-712 (1979).

Finally, plaintiff attempts to counter the strong policy argument, accepted by many courts[3], that option trad-

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3 *E.g., Laventhall v. General Dynamics Corp.*, 704 F.2d 407, 411 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983); *Data Controls North, Inc. v. Financial Corp. of America, Inc.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,958, at 90,446-90,447 (D. Md. May 23, 1988); *Starkman v. Warner Commu-*
(Footnote continued)

ers should be denied standing to sue the corporation because they contribute nothing to the corporation, by pointing out that the "logical conclusion" of such an argument is to deny standing to sue to purchasers of a corporation's securities on the open market because the consideration paid likewise does not inure to the corporation. To the contrary, such an argument is not only illogical, it is frivolous, as the existence of a secondary market for a corporation's securities provides a direct benefit to the corporation by enhancing its ability to successfully sell its securities to the public in the first place. Reilly, *Secondary Markets* in *Handbook of Financial Markets: Securities, Options, Futures* 135, 138 (F. Fabozzi & F. Zarb eds. 1981).

(Footnote 3 continued from previous page)
nications, Inc., 671 F. Supp. 297, 304-05 (S.D.N.Y. 1987); *In re McDonnell Douglas Corp. Sec. Litig.*, 567 F. Supp 126, 127 (E.D. Mo. 1983).

CONCLUSION

For the foregoing reasons, and for the reasons set forth in the petition, Petitioners respectfully submit that the petition for a writ of certiorari should be granted and the case set for oral argument.

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No. 88-36

In the Supreme Court of the United States

OCTOBER TERM, 1988

BENEFICIAL CORPORATION, ET AL., PETITIONERS

v.

ROBERT M. DEUTSCHMAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

Whether a purchaser of an option on a security has standing to sue the non-trading issuer of the underlying security under the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, for material misrepresentations made by the issuer.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is filed in response to the Court's invitation to the Solicitor General to express the views of the United States.

STATEMENT

1. This class action was brought pursuant to the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, by respondent Robert M. Deutschman against the petitioners, Beneficial Corporation and two of its officers. Respondent alleges that he and the class he seeks to represent were injured, as a result of false or misleading statements by petitioners, in connection with the purchase of publicly traded options to purchase shares of Beneficial stock.[1] Petitioners are

[1] Respondent seeks to assert claims on behalf of a class consisting of all investors who purchased either call options on Beneficial common stock *or* Beneficial common stock during a class period from August 21, 1986 through February 27, 1987 (Br. in Opp. App. ¶ 15). Respondent has not alleged, however, that he purchased any Beneficial common stock during this period (*id.* ¶ 6). The question whether respondent, as a purchaser of call options, may properly serve as a representative of a class consisting of persons who purchased Beneficial common stock was not passed upon by the lower courts and is not presented by the petition. See Pet. 4-5 n.1.

not alleged to have had a role in the issuance of the options.[2] Nor are petitioners alleged to have traded either in the options or in Beneficial stock during the class period.

Respondent alleges that in 1986 petitioners knowingly or recklessly made false or misleading statements (and failed to correct in a timely fashion statements known to be false or misleading) that significantly understated projected losses for the reinsurance segment of Beneficial's business.[3] Respondent alleges that he purchased his call options on the Pacific Stock Exchange at prices artificially inflated by the market's reliance on petitioners' fraudulent statements. When Beneficial's actual reinsurance losses became known, the price of Beneficial stock declined, remaining below the price at which the options could be exercised profitably. The options, whose price also had declined, expired in January 1987 without being exercised or sold. Respondent allegedly incurred out-of-pocket losses of approximately $14,000 in connection with his option purchases (Br. in Opp. App. ¶ 6).

2. The district court dismissed the complaint (Pet. App. 26a). Relying on *Chiarella* v. *United States*, 445 U.S. 222 (1980); *Dirks* v. *SEC*, 463 U.S. 646 (1983); and *Laventhall* v. *General Dynamics Corp.*, 704 F.2d 407 (8th Cir. 1982), cert. denied, 464 U.S. 846 (1983), the court held that an issuer may be sued for misrepresentations only if a transactional nexus or fiduciary relationship exists between the issuer and the plaintiff (Pet. App. 21a). The court noted that Beneficial neither issued nor traded option contracts, and therefore concluded that there was no transactional or fiduciary relationship between Beneficial

[2] Options listed on a securities exchange, such as the Beneficial options in question here, are issued by the Options Clearing Corporation and have standardized features to facilitate public trading. Beneficial did not cause its options to be listed and had no control over whether the options were listed.

[3] The alleged misrepresentations were made in letters from Beneficial's chairman and chief executive officer to its shareholders, corporate press releases, periodic reports filed with the Securities and Exchange Commission, and quotations attributed to Beneficial's officers appearing in the financial press (Compl. ¶¶ 21, 25(a), 28(b) and (c), 40(b) and (c), 42(a), 48, 50, *reprinted in* Br. in Opp. App 10a, 12a, 15a-16a, 24a-25a, 28a-29a).

and the purchasers of options. The court accordingly found that respondent lacked standing to sue Beneficial for false statements.[4] The court stated in support of its holding that option traders provide no more than a *de minimis* contribution to a corporation's capital formation (*id.* at 21a, 25a), and typically accept greater risk than purchasers of the underlying stock (*id.* at 25a). Moreover, since the corporation does not issue the options, it lacks any control over the number of options written with respect to its securities, and thus over its potential liability to option traders (*id.* at 24a). These factors, the court reasoned, counsel against permitting option traders to "recover at the expense of the corporation's shareholders" (*id.* at 25a).

3. The court of appeals reversed. The court found (Pet. App. 6a-9a) that respondent's complaint alleged each of the recognized elements of a cause of action under Rule 10b-5, including that petitioners made material misrepresentations with the requisite scienter, and that respondent, as a purchaser of securities, satisfied the standing requirement of *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975). The court refused to adopt any additional threshold standing requirements, not required by the language of the statute or the regulation, to deny a cause of action to option traders who allege injury from affirmative issuer misrepresentations.

The court rejected the district court's reliance on *Chiarella* and *Dirks* to impose a requirement of a fiduciary relationship between Beneficial and the option traders. The court explained (Pet. App. 9a-10a) that those insider trading decisions hold that a person is not liable under Rule 10b-5 for failing to disclose material information unless the person has a duty to disclose such information to the plaintiff, a duty that arises out of a fiduciary relationship. In contrast, the court stated (Pet. App.

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[4] The district court also read *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S 723 (1975), to require the plaintiff in a Rule 10b-5 action to be a purchaser or seller of securities "issued by the defendant corporation" (Pet. App. 22a (emphasis omitted)). Because the options were not issued by Beneficial, the court concluded that respondent failed to meet the standing requirement of *Blue Chip*. The court of appeals rejected that argument (Pet. App. 8a-9a), and petitioners do not seek this Court's review of that holding.

9a), liability for affirmative misrepresentations does not rest on breach of a duty of disclosure. While the complaint did not allege that Beneficial and its officers had a duty to disclose information to respondent, petitioners chose to speak, and "in speaking they were not free to lie" (*id.* at 10a).

The court likewise concluded that the district court's reliance on the Eighth Circuit's decision in *Laventhall* to impose a transactional nexus requirement was misplaced. That decision, the court explained, involved only a claim by an option trader against a corporation based on the corporation's failure to disclose information when trading in its own securities. The defendants there did not make affirmative misrepresentations to the public. In contrast, the court found, neither this Court nor any court of appeals has required a transactional nexus between a plaintiff and a defendant in a Rule 10b-5 case involving affirmative misrepresentations (Pet. App. 10a-11a).

Finally, the court rejected petitioners' policy arguments for limiting option traders' standing. The court questioned the district court's assumptions that option traders assume greater risk than equity holders, and that they contribute less than equity traders do to capital formation. The court observed that options frequently are used to hedge risk (Pet. App. 12a), and may contribute to market liquidity for the issuer's securities (*id.* at 13a). In any event, the court stated, the utility of options was a matter more properly left for legislative determination, and courts should not second-guess Congress's judgment to treat options as securities subject to the protection of the federal securities laws (*id.* at 12a-13a).

DISCUSSION

The decision below is the first by a court of appeals to address the standing of option traders to sue the issuer of the underlying security under Rule 10b-5 for affirmative misrepresentations. The court of appeals' rejection of a rule that would deny standing to option traders under these circumstances is consistent with the language and purposes of Rule 10b-5 and with the decisions of this Court, and does not conflict with the decision of

any other court of appeals. Nor do the policy considerations advanced by petitioners require imposition of a new standing limitation on Rule 10b-5 private actions by options traders. Accordingly, this Court's review of the question presented is not warranted at this time.

1. A fundamental purpose of the Securities Exchange Act of 1934 (Exchange Act) is to promote full and accurate disclosure of information by corporations in order "to protect investors against manipulation of stock prices." *Basic Inc.* v. *Levinson,* 108 S. Ct. 978, 982 (1988). This Court has long recognized that one of the "essential tool[s]" in achieving this purpose is the private right of action implied under Section 10(b) and Rule 10b-5. *Basic*, 108 S. Ct. at 982-983; *Herman & MacLean* v. *Huddleston,* 459 U.S. 375, 380 n.10 (1983); *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 196 (1976); *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 730 (1975); *Superintendent of Insurance* v. *Bankers Life & Cas. Co.,* 404 U.S. 6, 13 n.9 (1971).

a. An action under Section 10(b) and Rule 10b-5 "can be brought by a purchaser or seller of '*any* security' against '*any* person' who has used '*any* manipulative or deceptive device or contrivance.' " *Herman & MacLean* v. *Huddleston,* 459 U.S. at 382. The court of appeals correctly concluded (Pet. App. 7a-9a) that option traders fall within the broad language of the Rule describing the class of persons protected.[5]

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[5] Contrary to petitioners (Pet. 12-14), we do not believe that the decision below conflicts with *Cort* v. *Ash,* 422 U.S. 66 (1975), or any other decision of this Court regarding the general standards for implying a cause of action from a federal statute or regulation. An implied right of action under Rule 10b-5 has long been enforced by the courts, and sanctioned by congressional acquiescence. *Basic,* 108 S. Ct. at 982-983. The existence of such an action "is simply beyond peradventure." *Herman & MacLean* v. *Huddleston,* 459 U.S. at 380 & n.10. Thus, we do not agree with petitioner's contention (Pet. 14) that, to find standing, there must be an "unmistakable focus" on option traders in Section 10(b) and Rule 10b-5. Those provisions, which do not mention any type of security by name, focus on options to the same degree as they do on any other type of security. Petitioners also err is suggesting (Pet. 13) that, to find standing, there must be a "pervasive legislative scheme governing the relationships at issue between the plaintiff group and the defendant." Peti-

There can be no question that the phrase "any security" as used in Section 10(b) and Rule 10b-5 includes publicly traded options, such as the call options on Beneficial common stock acquired by respondent. Section 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10), defines "security" to include "any put, call, straddle, option, or privilege on any security." Since its creation, the Securities and Exchange Commission (SEC) has exercised regulatory authority over trading in options on securities. H.R. Rep. No. 626, 97th Cong., 2d Sess. 3-4, 6 (1982). The definition of a "security" was amended in 1982 (Act of Oct. 13, 1982, Pub. L. No. 97-303, § 1, 96 Stat. 1409) specifically to include options on securities in order to clarify and confirm that historic regulatory authority and to resolve uncertainty over the jurisdictional boundaries between the authority of the SEC and the Commodity Futures Trading Commission. H.R. Rep. No. 626, *supra,* at 3-4, 6-8.[6]

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tioners cite no case that, in finding standing under Section 10(b) and Rule 10b-5, has rested its analysis on the existence of such a legislative scheme

[6] Congress again confirmed this understanding when it amended the Exchange Act to make explicit that insider trading in the options markets is unlawful to the same extent as it is in the markets for the underlying securities. The Insider Trading Sanctions Act of 1984 (ITSA), Pub. L. No. 98-376, § 5, 98 Stat. 1265, added Section 20(d) to the Exchange Act, 15 U.S.C. 78t(d) (Supp. V 1987). That section provides that whenever trading in a security while in possession of material, nonpublic information would violate the securities laws or rules thereunder or result in liability to a purchaser or seller of the security, "such conduct in connection with a purchase or sale of a[n] * * * option * * * with respect to such security * * * shall also violate and result in comparable liability to any purchaser or seller of that security." Although ITSA concerns only liability for insider trading, and thus is not directly applicable to a case involving affirmative misrepresentations, it reflects Congress's intention that traders in option contracts should be treated no differently from traders in other securities for purposes of determining liability under Section 10(b) and Rule 10b-5. See 130 Cong. Rec. 20,107-20,108 (June 29, 1984) (statement of Sen. D'Amato); 130 Cong. Rec. 20,968-20,969 (July 25, 1984) (statement of Rep. Dingell). Commentators have noted that Section 20(d), 15 U.S.C. 78t(d), provides standing for options traders to sue for insider trading under Rule 10b-5. See L. Loss, *Fundamentals of Securities Regulation* 732-733 n.29 (1988); Wang, *A Cause of Action of Option Traders Against Insider Option Traders,* 101 Harv. L. Rev. 1056 (1988).

Furthermore, respondent has satisfied the statutory requirement of pleading fraud "in connection with the purchase or sale of any security." In order to have standing to sue under Rule 10b-5, a plaintiff must allege that he either purchased or sold a security, *Blue Chip Stamps, supra,* and that the deceptive practice "touched" that purchase or sale, *Superintendent of Insurance* v. *Bankers Life & Cas. Co.,* 404 U.S. at 12-13. These requirements are readily satisfied in this case: the complaint alleges (Br. in Opp. App. 30a) that respondent purchased call options on Beneficial stock "at artificially inflated prices and in a false market climate created by [petitioners]." See *Blue Chip Stamps,* 421 U.S. at 751 ("the holders of puts, calls, options and other contractual rights or duties to purchase or sell securities have been recognized as 'purchasers' or 'sellers' of securities for purposes of Rule 10b-5 * * * because the definitional provisions of the 1934 Act themselves grant them such a status.").

Finally, the "in connection with the purchase or sale" language does not require that the *defendant* must be engaged in the purchase or sale of the security in question. Any such requirement would mean that a corporation could not be sued by its own shareholders (or for that matter by the SEC in an enforcement action) for affirmative misrepresentations unless it was simultaneously trading in its own shares. Yet private as well as government actions against the issuer of a security for material misrepresentations have long been recognized to satisfy the "in connection with the purchase or sale" requirement of Rule 10b-5. See *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 858-862 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); *Mitchell* v. *Texas Gulf Sulphur Co.,* 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971); *Heit* v. *Weitzen,* 402 F.2d 909 (2d Cir. 1968), cert. denied, 395 U.S. 903 (1969); L. Loss, *Fundamentals of Securities Regulation* 736, 799-800 (1988).[7]

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[7] Petitioners' proposed standing limitation – requiring that there be "some relationship or transactional nexus" (Pet. 7, 15) between the plaintiff and the defendant – would perhaps have some textual foundation if the statute and the

In short, the court of appeals was clearly correct insofar as it discerned no basis in the language of the statute or the Rule to adopt a special limitation on the standing of options traders to bring a private action against the issuer of the underlying security for affirmative misrepresentations.

b. Relying on this Court's recent insider trading decisions in *Dirks* v. *SEC,* 463 U.S. 646 (1983), and *Chiarella* v. *United States,* 445 U.S. 222 (1980), petitioners argue (Pet. 15) that an options trader cannot bring a Rule 10b-5 action against a corporation unless the corporation has some kind of fiduciary relationship or duty to the options trader. As the court of appeals properly held (Pet. App. 9a), however, the fiduciary duty requirement of those cases has no application in the context of claims based on affirmative misrepresentations.

Dirks and *Chiarella* require a breach of a fiduciary relationship (or a similar relation of trust and confidence) before liability may be imposed for *silence* by persons trading while in possession of material, nonpublic information. The finding of a fiduciary duty is necessary in this context to infer a duty to disclose; otherwise, mere silence is not unlawful. See *Dirks,* 463 U.S. at 657-658; *Chiarella,* 445 U.S. at 235.

As this Court expressly recognized in *Chiarella,* however, a person who owes no duty to disclose may still commit fraud if he chooses to speak and speaks falsely (445 U.S. at 227-228).[8]

Rule were written so as to prohibit the use of any misrepresentation or manipulative or deceptive device "in connection *with a security.*" Such a hypothetical statute would arguably suggest the need for a "connection" between the defendant and the particular security purchased or sold by the plaintiff. But of course the statute and the Rule do not say this. They prohibit the use of any misrepresentation or manipulative device "in connection with *the purchase or sale* of any security." The language of the Rule thus suggests that the required nexus or connection is not between the defendant's conduct and a particular security, but between the defendant's conduct and the plaintiff's purchase or sale. In other words, the language of the statute and rule supports the *Blue Chip Stamps* purchaser-seller standing limitation, but not petitioners' proposed standing limitation.

[8] "At common law, misrepresentations made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits

And the Court made it abundantly clear in *Basic* that Rule 10b-5 applies to "*affirmative misrepresentations* by those under no duty to disclose, (but under the ever-present duty not to mislead)" (108 S. Ct. at 988 n.18 (emphasis added)). The Court reaffirmed that "Rule 10b-5 is violated whenever assertions are made * * * in a manner reasonably calculated to influence the investing public, . . . if such assertions are false or misleading or are so incomplete as to mislead." *Basic,* 108 S. Ct. at 985 n.13 (quoting *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969)).[9]

The policy of the securities laws to encourage "honest publicity" (*Basic,* 108 S. Ct. at 982) and to protect investors against "any manipulative or deceptive device or contrivance" in violation of the rules of the Securities and Exchange Commission (§ 10(b), 15 U.S.C. 78j(b)) would be severely impaired by an arbitrary requirement of a fiduciary duty in cases involving allegations of affirmative misstatements. Courts have not demanded such a duty to trigger liability for misrepresentations under Rule 10b-5. See, *e.g., Manufacturers Hanover Trust Co.* v. *Drysdale Securities Corp.*, 801 F.2d 13, 20-22 (2d Cir. 1986), cert. denied,

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fraud only when he is under a duty to do so." *Chiarella,* 445 U.S. at 227-228. See also *Basic,* 108 S. Ct. at 987 n.17.

[9] The distinction between silence, on the one hand, and false or misleading statements, on the other, draws directly upon the language of Rule 10b-5 itself. Rule 10b-5(b) makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading * * * in connection with the purchase or sale of any security." In *Chiarella,* the Court took care to point out (445 U.S. at 225 n.5) that its decision did not involve Rule 10b-5(b), but involved only Rule 10b-5(a) and (c). Those provisions bar, respectively, the employment of "any device, scheme, or artifice to defraud" and engaging in "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person" (445 U.S. at 226). While a duty to disclose (created by a fiduciary relationship) is needed to make silence fraudulent under those provisions of the rule, it wrenches the Court's reasoning wholly out of context to insist that affirmative misrepresentations that expressly violate Rule 10b-5(b) give rise to no liability to options traders in the absence of a fiduciary relationship.

479 U.S. 1066 (1987); *Braun* v. *Northern Ohio Bank*, 430 F. Supp. 367, 371-380 (N.D. Ohio 1977).[10] Nothing in *Chiarella* or *Dirks* requires a different result.

For essentially the same reason, we do not believe that the decision below conflicts with the Eighth Circuit's decision in *Laventhall* v. *General Dynamics Corp.*, 704 F.2d 407 (1982) cert. denied, 464 U.S. 846 (1983). *Laventhall* did not concern liability for affirmative misrepresentations, and the Eighth Circuit's decision did not address that issue. In reaching a result that the Eighth Circuit itself characterized as "not free from doubt" (*id.* at 410), the *Laventhall* court held only that option traders could not sue the issuer of the underlying stock for *nondisclosure,* when the issuer had not engaged in options trading (*id.* at 412-413).

Because *Laventhall* was a nondisclosure case, the key issue was whether the relationship between option traders and corporate issuers gives rise to a duty of disclosure. 704 F.2d at 411-412. The court concluded that there was no duty of disclosure in these circumstances since, in its view, the issuer of an underlying security does not owe any fiduciary duty to traders in options that it did not issue. Moreover, the court held, even if the issuer stood in a fiduciary relationship to option traders, a duty to disclose information to option traders would have been triggered only if the issuer had also been a trader in options. The issuer, however, had traded only in the underlying stock, and not in options. Thus, the Eighth Circuit simply refused to impose *insider trading* liability when the plaintiff and defendant were trading in different markets.[11]

[10] See also 5A A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 66.01[a], at 3-414 to 3-415 (rev. 2d ed. 1988) ("Nor is there now any question [under Rule 10b-5] that C can be held responsible for causing D to trade with E, even though C is unrelated to E, derives no benefit from the transaction, and is not a fiduciary of D." (footnotes omitted)); Cox, *Choices: Paving the Road Toward a "Definition" of Insider Trading,* 39 Ala. L. Rev. 381, 394-396 (1988) (criticizing cases, including the district court decision in this case, that rely on *Chiarella* to require a fiduciary duty before imposing liability for affirmative misrepresentations).

[11] The *Laventhall* court explained (704 F.2d at 414) that analogous limits on insider trading liability exist for persons trading in the same market, when the

c. The Third Circuit was also correct, in this case in finding that policy reasons do not support the denial of standing to option traders (Pet. App. 11a-13a). In general, allowing a private right of action by securities traders injured by fraud strengthens the overall enforcement of the federal securities laws, increases incentives for honesty in the nation's capital markets, and promotes the efficient operation of those markets. Such actions serve as a necessary supplement to the Commission's own enforcement of the securities laws. *Basic,* 108 S. Ct. at 983; *Bateman Eichler, Hill Richards, Inc.* v. *Berner,* 472 U.S. 299, 311 (1985); *J.I. Case Co.* v. *Borak,* 377 U.S. 426, 432 (1964). These considerations, which support the recognition of standing for options traders, are not outweighed by the policy concerns urged by petitioners.

(1) Petitioners suggest that it is unnecessary to grant standing to options traders in order to deter issuer fraud, because option traders simply duplicate the deterrent role played by investors in the issuer's securities (Pet. 23-24). There is some force to this contention. Options are traded only where there is a large and active market in the underlying security. Thus, for that reason, any injury suffered by options traders because of affirmative issuer misrepresentations will presumably also be visited on persons who have traded in the underlying security as well. Consequently, recognizing standing on the part of options traders often will not determine whether or not a suit is brought, but only the level of damages if it is successful.

That does not mean, however, that there will not be some cases in which only option traders will have an adequate incentive to sue.[12] Option traders may suffer losses that are propor-

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plaintiff's trading is not contemporaneous with that of the defendant. See *Wilson* v. *Comtech Telecommunications Corp.*, 648 F.2d 88, 94 (2d Cir. 1981) (limiting insider trading liability to "those investors trading contemporaneously with the insider"); Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 5, 102 Stat. 4680 (codifying right of action for contemporaneous traders); H.R. Rep. No. 910, 100th Cong., 2d. Sess. 26-27 (1988) (approving case law development of the term "contemporaneous," citing, inter alia, *Wilson, supra*).

[12] Note, *Private Causes of Action for Option Investors Under SEC Rule 10b-5: A Policy, Doctrinal, and Economic Analysis,* 100 Harv. L. Rev. 1959, 1963 & n.25 (1987).

tionately greater than those of investors in stock, in part because of the possibility of a partial or total loss of the premium paid on an option that expires without being sold or exercised. Thus, option traders may have a greater incentive to sue in cases where misleading statements produce only a relatively small movement in the price of the underlying security. And of course, even if investors in stock do sue, requiring issuers who commit fraud to pay additional damages for injuries sustained by options traders will increase the deterrent effect of the law.[13]

In addition to deterring future violations, civil remedies are meant to compensate victims. *Randall* v. *Loftsgaarden,* 478 U.S. 647, 664 (1986); S. Rep. No. 792, 73d Cong., 2d Sess. 12 (1934) ("[I]f an investor has suffered loss by reason of illicit practices, it is equitable that he should be allowed to recover damages from the guilty party."). An arbitrary limitation on the standing of option traders would leave unremedied the economic harm to option investors flowing directly from issuers' fraud.

(2) Petitioners also assert (Pet. 22, 24-26) that affording standing to option traders will result in enormous potential liability for issuers over which they have no control. However, petitioners' intimations of vast numbers of options traders waiting in the wings to file suit is unsubstantiated. The allegations in the complaint in this case indicate, for example, that the number of options is likely to be a fraction of both the number of shares outstanding and the number of shares traded.[14] There

[13] This is not a situation, such as the Court confronted in *Illinois Brick Co.* v. *Illinois,* 431 U.S. 720 (1977), where affording standing to persons who suffer derivative injuries would either diminish the incentives of those who suffer primary injuries or would result in multiple recoveries for the same injury. The injury that an investor in stock incurs because of fraudulent misstatements by a corporation is in no sense "passed on" to options traders. Rather, investors in stock and options traders deal in different securities traded in different markets, and they suffer distinct injuries as a result of the issuer's misconduct.

[14] The complaint alleges that Beneficial Corporation had more than 22 million shares outstanding in the latter part of 1986, while, during the class period, about 50,000 call options (representing rights to acquire 5,000,000

are in fact several legal and practical restraints on option trading that impose limits on the number of options that may be written.[15]

Petitioners also ignore certain elements of a private Rule 10b-5 action that tend to reduce the scope of potential liability, each of which would apply to actions brought by options traders no less than other plaintiffs. Rule 10b-5 plaintiffs must prove scienter, which precludes issuer liability for negligent oversight or mistaken judgment. See *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976). They must also show that any misstatements that have been made are material to investors. See *Basic,* 108 S. Ct. at 983. And private plaintiffs suing for damages must prove that they relied on such misstatements. See *id.* at 989.

Furthermore, even if petitioners' prediction of a vast expansion of liability were correct, it is not clear that this concern should be addressed by means of a restrictive standing rule.[16]

shares) were sold. During that same period, the sales volume for Beneficial common stock was about 36 million shares (Br. in Opp. App. ¶¶ 7(d) and (e), 16).

[15] Option investors must meet certain suitability criteria that restrict the eligible pool of option investors. See, *e.g.*, Rules of the Board of Governors of the American Stock Exchange, Rule 923; Chicago Board Options Exchange, Inc., Rule 9.9. Investors are also subject to limits on the size of their positions and the amount of their position that they can exercise within given periods. See, *e.g.*, Rules of the Board of Governors of the American Stock Exchange, Rules 904, 905; Chicago Board Options Exchange, Inc., Rules 4.11, 4.12. Writers of uncovered call options—in which where the writer neither owns the underlying interest deliverable upon exercise of the call option nor possesses an offsetting option position—are required to meet margin requirements. 12 C.F.R. 220.5, 220.18; see The Options Clearing Corporation Rules 601 *et. seq*; Chicago Board Options Exchange, Inc., Rule 12.3. Finally, some private investors write call options on a covered basis. The willingness of such investors to engage in options trading is, in part, limited by the available outstanding shares of an issuer's stock.

[16] The concern with expanded liability voiced by petitioners is different in kind from the concerns cited by this Court in *Blue Chip Stamps* in support of the purchaser-seller standing requirement. See 421 U.S. at 730. The *Blue Chip Stamps* Court, in denying standing to persons who claimed they did *not* trade because they relied on fraud, was concerned with an expansion of issuers' liability resulting from the potentially fraudulent and unverifiable nature of

An alternative approach would be to impose a limitation on damages, for example, by applying to options traders an out-of-pocket-loss measure of damages, rather than a benefit-of-the-bargain measure.[17] Addressing petitioners' concerns about extensive liability through appropriate limitations on damages, rather than as a matter of standing, would also enable courts to evaluate the concerns raised by petitioners about the scope of potential liability on the basis of actual numbers, rather than mere speculation.[18]

Finally, even if some limitation on standing were thought to be desirable, it is far from evident that petitioners' proposed fiduciary relationship standard—requiring that the plaintiff show "some relationship or transactional nexus" to the defendant (Pet. 7, 15)—is the proper limiting principle. Petitioners' proposed standing limitation is more restrictive than the standing requirements that obtain under the common law of fraud. In cases of affirmative misrepresentation, the common law permits an action for fraud to be brought by any person who could be expected to rely on the misrepresentation, even if that person is a stranger to whom no fiduciary duty is owed and with whom no business has been transacted. See *Ultramares Corp.* v. *Touche, Niven & Co.*, 255 N.Y. 170, 174 N.E. 441 (1931). See also *Rusch Factor, Inc.* v. *Levin*, 284 F. Supp. 85, 90 (D.R.I. 1968) (applying Rhode Island law); *Haberman* v. *Washington Public Power Supply System*, 109 Wash. 2d 107, 165-170, 744 P.2d 1032, 1069-1071 (1987) (en banc), as amended, 750 P.2d

claims by non-traders. *Id.* at 142-144. In contrast, any expansion in liability here is caused by requiring issuers to compensate a separate class of investors who are nonetheless foreseeably injured by issuer fraud.

[17] Cf. *SEC* v. *Certain Unknown Purchasers of the Common Stock of and Call Options for the Common Stock of Santa Fe International Corp.*, 817 F.2d 1018 (2d Cir. 1987) (court approved plan, in SEC enforcement action, for distributing funds disgorged by defendant, under which losses of person trading options were offset by profits realized by that person in stock transactions), cert. denied, 108 S. Ct. 1013 (1988).

[18] See *Elkind* v. *Liggett & Myers, Inc.*, 635 F.2d 156, 168 (2d Cir. 1980); *Shapiro* v. *Merrill Lynch, Pierce Fenner & Smith*, 495 F.2d 228, 241-242 (2d Cir. 1974). The task of fashioning an appropriate measure of damages is best left to the lower courts in the first instance.

254, appeal dismissed, 109 S. Ct. 35 (1988); Restatement (Second) of Torts § 531 (1977) ("One who makes a fraudulent misrepresentation is subject to liability to the person or class of persons whom he * * * has reason to expect to act or to refrain from action in reliance upon the misrepresentation * * *."); *id.* §§ 533, 536; Prosser, *Misrepresentation and Third Persons,* 19 Vand. L. Rev. 231, 243-246 (1966). It would be odd to import a standing limitation into Rule 10b-5 actions—not otherwise required by the language of the statute or the Rule—that is more restrictive than the common-law rule, given that one of Congress's objectives in enacting Section 10(b) was to "rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct." *Herman & MacLean* v. *Huddleston,* 459 U.S. 375, 388-389 (1983); see also *Basic,* 108 S. Ct. at 990 n.22; *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180, 194-195 (1963).

Under the common law's foreseeability requirement, we think options traders would clearly have standing. The price of an option depends critically and predictably on the price of the underlying stock.[19] Because of the close connection between the stock and option markets, issuer misrepresentations that are "reasonably calculated to influence the investing public" (*SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 862 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969)), will foreseeably induce reliance by traders in options on their stock. Just as stock and

[19] The value of an option depends on the price of the underlying stock, the exercise price of the option, interest rates, the time remaining to the option's expiration, and the volatility of the underlying stock price. As the price of the underlying stock increases, the value of any call option on that stock increases; as the price of the underlying stock declines, the value of the call option declines. See, *e.g.*, R. Brealey & S. Myers, *Principles of Corporate Finance* 484 (3d ed. 1988). Several formulas estimate the value of a put or call option based on the price of the underlying stock and the other factors cited above. The best known formula is the Black-Scholes options pricing model. *Id.* at 485-488 ("Every day dealers on the options exchange use this formula to make huge trades."). See also G. Gastineau, *The Options Manual* 189-210 (3d ed. 1988) for a discussion of other options pricing formulas and models. For a general discussion of option valuation, see J. Cox & M. Rubinstein, *Options Markets* (1985).

option traders both rely on issuer statements to facilitate informed investment decisions, so do they both suffer harm from false or misleading issuer representations.[20]

(3) Petitioners next suggest (Pet. 25) that it is unfair to allow option traders to recover damages from an issuer and thereby take money out of the pockets of shareholders. Shareholders, however, invariably bear the financial consequences for torts committed by corporations on third parties. And, contrary to petitioners' contention (Pet. 26-27), option traders are not, because of the supposed speculative and risky nature of option trading, less deserving of protection under the securities laws than an issuer's own security holders.[21] In any event, as the court of appeals noted (Pet. App. 12a), option trading provides many investors with a way to transfer and hedge against, as opposed to increasing, risk.[22]

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[20] Petitioners argue (Pet. 15-16) that the fraud-on-the-market theory of indirect reliance should not apply here. Review of that question, which is not presented as a separate question by petitioners, and which was not decided by the courts below, is not warranted. Petitioners' fraud-on-the-market contention has no relevance to their standing argument, since they challenge the standing even of option traders who directly rely on a defendant's misstatements.

[21] *Basic*, 108 S. Ct. at 991 ("No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells.") (quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934). Cf. *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran*, 456 U.S. 353, 389 (1982) (expressly rejecting the suggestion that characterization of persons who invest in futures contracts as "speculators" is a basis for excluding them from the class of persons protected under the antifraud provisions of the Commodity Exchange Act).

[22] See Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, and Securities and Exchange Commission, *A Study of the Effects on the Economy of Trading in Futures and Options* II-15 to II-20 (1984) [hereinafter *Study of Trading in Futures and Options*]; Staff of Securities and Exchange Commission, *Report of the Special Study of the Options Markets*, transmitted to the House Committee on Interstate and Foreign Commerce, 96th Cong., 1st Sess. 82-90 (Comm. Print 1978); J. Cox & M. Rubinstein, *Option Markets* 444-445 (1985); cf. *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran*, 456 U.S. 353, 358 (1982) (futures trading in the commodity markets allows hedging which is "facilitated by the availability of speculators willing to assume the market risk that the hedging farmer or processor wants

(4) Finally, petitioners' assertion (Pet. 23) that option traders do not benefit the issuer of the underlying security is incorrect. Although option trading does not contribute directly to the capital of the issuer of the underlying security, neither does secondary trading in the issuer's common stock. As with secondary trading in stock, however, option trading does facilitate capital formation by enhancing liquidity in the secondary markets for issuers' securities, thereby assuring that persons who buy securities from an issuer will be able to resell them readily.[23] And the existence of an options market in an issuer's securities can enhance the attractiveness of the underlying stock by providing investors with an opportunity to earn extra profits or to limit losses. Thus, option trading is recognized as highly beneficial to the functioning of capital markets, and as indirectly serving to reduce corporations' cost of capital.

On balance, we believe that affording standing to option traders furthers the statutory goals of assuring honest and efficient securities markets and of protecting investors. There is no adequate reason to deny a remedy to option traders who can otherwise establish liability under Rule 10b-5 based on affirmative issuer misstatements.

2. Several additional considerations reinforce our conclusion that the standing question decided by the Third Circuit does not call for this Court's immediate review without further development of the issue in the lower courts. First, apart from the decision below, a relatively small number of district courts have considered whether option traders have standing to sue for affirmative misrepresentations.[24] The majority of courts that

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to avoid"); *United States* v. *Dial*, 757 F.2d 163 (7th Cir.) (same), cert. denied, 474 U.S. 838 (1985).

[23] See *Study of Trading in Futures and Options* at II-24; Note, *Securities Regulation for a Changing Market: Option Trader Standing Under Rule 10b-5*, 97 Yale L. J. 623, 632 (1988).

[24] Three district court decisions have squarely held that purchasers of call options have standing under Rule 10b-5 to assert claims against a non-trading issuer of the underlying stock for affirmative misrepresentations. *Tolan* v. *Computervision Corp.*, 696 F. Supp. 771 (D. Mass. 1988); *In re Digital Equipment Corp. Securities Lit.*, 601 F. Supp. 311, 315 (D. Mass. 1984); *Lloyd* v.

have rendered holdings squarely on point have agreed with the court below that there is standing in these circumstances. There is no indication at this time that the courts of appeals will not reach consistent results on this issue.

Second, the lower courts have not yet addressed a number of important aspects of option trader suits, beyond the threshold question of standing, that are highly relevant to evaluating the practical impact of such litigation. For example, the measure of damages for any injuries to option traders under Rule 10b-5 was not addressed by the court below. Likewise, contrary to petitioner's suggestion (Pet. 15-16), the court did not pass on the application of the fraud-on-the-market theory to option traders. Any ultimate consideration by this Court of the standing of option traders under Rule 10b-5 would benefit from the experiences of the lower courts in working out these issues.

Third, the threshold standing issue decided in this case creates neither the need nor the opportunity for this Court to address the hypothetical questions that petitioners note about suits by holders of other types of derivative securities. For example, petitioners raise the spectre that, if standing is granted to option traders, issuer liability will be "limited only by the imagination of the financial industry in creating new security instruments based in any way on a corporation's performance" (Pet. 24).

Industrial Bio-Test Laboratories, Inc., 454 F. Supp. 807, 813 (S.D.N.Y. 1978). Only one district court decision squarely to the contrary remains unreversed. *Bianco* v. *Texas Instruments, Inc.*, 627 F. Supp. 154, 161 (N.D. Ill. 1985).

Some cases have found no standing for option traders suing on insider trading or other nondisclosure theories. See *Data Controls North, Inc.* v. *Financial Corp. of America*, 688 F. Supp. 1047, 1049 (D. Md. 1988) (denying standing to option traders in the absence of evidence of affirmative misrepresentations; distinguishing the Third Circuit's decision in this case), affirmed on other grounds, No. 88-2866 (4th Cir. May 3, 1989) (unpublished opinion); *Starkman* v. *Warner Communications, Inc.*, 671 F. Supp. 297, 305 (S.D.N.Y. 1987) (denying standing to option traders suing on the same insider trading theory that was rejected in *Laventhall*); *In re McDonnell Douglass Corp. Securities Litigation*, 567 F. Supp. 126 (E.D. Mo. 1983) (denying standing to option traders alleging failure to disclose by a non-trading issuer and insider trading based on defendant's transactions in the issuer's stock).

Petitioners specifically refer (Pet. 10-11) to options on an index based on a number of securities. But the issue of what liability might exist to traders in such "market basket" securities is not presented in this case. A grant of certiorari would not be warranted in an effort to define such abstract limitations on Rule 10b-5.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 88-36

In the Supreme Court of the United States

OCTOBER TERM, 1988

BENEFICIAL CORPORATION, FINN M.W. CASPERSEN,
ANDREW C. HALVORSEN, PETITIONERS

v.

ROBERT M. DEUTSCHMAN, RESPONDENT

**On Petition for a Writ of Certiorari to the
United States Court of Appeals
for the Third Circuit**

SUPPLEMENTAL BRIEF FOR THE PETITIONERS

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SUPPLEMENTAL BRIEF FOR THE PETITIONERS

Pursuant to Rule 22.6 of the Rules of this Court, petitioners submit this supplemental brief in response to the *amicus curiae* brief filed by the United States on May 23, 1989.

The government's brief appears to recognize that the court of appeals' legal analysis exposes nontrading corporations to virtually unlimited damages liability under Section 10(b) and that a lower court decision espousing such a rule would merit this Court's attention. Accordingly, the government has carefully attempted to cabin the court of appeals' rationale, depicting this as a case concerning only "standing of options traders" (Br. 4). In the government's view, the decision below does not address the extent to which a nontrading corporation may be held liable in damages under Section 10(b) to persons trading in other types of securities issued by entities other than the corporation itself (Br. 18-19).

Unfortunately, the premise of the government's submission is demonstrably false. The court of appeals' analysis—like the analysis in the government's own brief—leaves no room for any distinction between options and other securities not issued by the defendant corporation. To the contrary, the legal rule adopted by the court below and endorsed by the government extends the Section 10(b) implied right of action to traders in *all* such unrelated securities.

Once the government's unrealistically myopic view of the case is corrected, the significance of the Third Circuit's decision becomes clear: nontrading corporations would be subject to wide-ranging, essentially unlimited damages liability. The question whether Section 10(b) imposes such open-ended liability is an issue of considerable practical importance to the business community on which the lower courts have reached differing conclusions. The petition for a writ of certiorari should be granted.

A. The Court Of Appeals' Decision Conflicts With The Language Of The Statute And The Principles For Construing Section 10(b) Set Forth In This Court's Decisions

The government suggests (Br. 4-8) that the Third Circuit's decision is simply a logical extension of prior case law defining the scope of the private right of action implied under Section 10(b). That is plainly incorrect. Citing this Court's observation that "[w]hen we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn" (*Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 737 (1975)), the district court correctly recognized that the issue in this case is whether the "oak" should be "engrafted with a new limb from which numerous branches would inevitably sprout." Pet. App. 18a. Until now, a nontrading corporation's liability in damages for public misrepresentations has extended only to persons who traded in securities *issued by the corporation itself* (see, *e.g.*, *Basic Inc.* v. *Levinson*, 108 S.Ct. 978 (1988)); the decision below breaks new ground by holding the corporation liable to persons who traded in securities *issued by other entities*.[1]

1. It is important to emphasize at the outset that this Court has *never* held that a corporation may be subjected to liability under Section 10(b) for public misrepresentations where the corporation itself did not participate in the trading of the securities that were the focus of the

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[1] This case involves only the scope of the private right of action implied under Section 10(b). Despite a hint by the government to the contrary (Br. 7), the authority of the Securities and Exchange Commission to obtain injunctive relief is not in dispute and would not be limited by the standing rule that we advocate. Cf. *Blue Chip Stamps*, 421 U.S. at 751 n.14.

Similarly, there is no question that options are securities within the meaning of Section 10(b). (The government's discussion of this matter (Br. 6) is thus completely irrelevant.) The issue here is whether an options trader may maintain an action for damages under that provision against a nontrading corporation *other than* the issuer of the options.

alleged fraud. Justices White and O'Connor observed in their separate opinion in *Basic Inc.* v. *Levinson*, *supra*, that "'[i]mposition of damages liability under Rule 10b-5 makes little sense . . . where a defendant is neither a purchaser nor a seller of securities.' * * * [I]t is difficult to square liability in [such a] case with § 10(b)'s express provision that it prohibits fraud '*in connection with* the purchase or sale of any security.'" 108 S.Ct. at 998 (citations omitted; emphasis in original). The four-Justice majority in *Basic* did not address the issue; the Chief Justice, Justice Scalia, and Justice Kennedy did not participate.

The situation here is even farther removed from Section 10(b)'s language than the one criticized in *Basic*. At least the nontrading corporation in *Basic* was being sued by persons who, allegedly in reliance on public misrepresentations made by the corporation, had traded in the corporation's own securities. In view of the preexisting relationship between the corporation and its own securities, all of the corporation's statements might in some sense be said to have a "connection with" trades in those securities. Here, as the government acknowledges (Br. 2-3 & n.2), there is absolutely *no* connection between Beneficial Corporation and the options purchased by respondent. Not only did Beneficial not trade in those securities, but it also did not issue them. It is therefore impossible to see how Beneficial's statements are "connect[ed]" in any way to trading in these wholly unrelated securities. Thus, nothing in the language of Section 10(b) authorizes respondent's cause of action.

The government's analysis of the statutory language is quite bizarre. It concedes (Br. 7-8 n.7) that if the statute prohibited an unlawful act "in connection with a security," the plaintiff would be required to prove the existence of a relationship between the defendant corporation and the security. According to the government, however, the existing statute—which makes it unlawful for any person to use or employ a manipulative or deceptive device "in connection with the purchase or sale of

any security"—shifts the test to a subjective standard demanding proof only that the plaintiff's own decision to trade was affected by the corporation's misstatement.

The government does not explain why this seemingly inconsequential difference in wording should change the standard from an objective test to a subjective one looking to the plaintiff's own decisionmaking process. The statute remains focused on the relationship between the defendant and the securities transaction at issue: *i.e.*, whether the *defendant* used or employed an unlawful device in connection with the purchase or sale of the particular securities. Moreover, the government's approach has the additional defect of rendering this element of the cause of action wholly duplicative of the materiality and reliance requirements. Whenever a plaintiff has satisfied the latter tests, he would of necessity have established that, in his view, the challenged conduct occurred "in connection with" the securities transaction. This construction of the statute would therefore be inconsistent with the well-settled principle that statutes should be interpreted to give effect to all of their terms.[2]

2. This Court has held that, in determining the scope of the judicially-created private right of action under Section 10(b), courts should take policy considerations into account in "flesh[ing] out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance." *Blue Chip Stamps*, 421 U.S. at 737; see also *Santa Fe Industries* v. *Green*, 430 U.S. 462, 477-479 (1979). Because the court of appeals' construction of Section 10(b) would lead to an unprecedented—and un-

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[2] The government somewhat mysteriously asserts (Br. 3 n.4) that we do not rely on the district court's determination that *Blue Chip Stamps* requires a Section 10(b) plaintiff to show that he traded in securities issued by the defendant corporation. As we have discussed, our argument is precisely that: a plaintiff in this sort of Section 10(b) action has standing only if he has traded in securities issued by the defendant.

justified—expansion in the scope of damages liability, that interpretation of the statute should be rejected.[3]

Contrary to the government's repeated assertions (Br. 5, 8, 11-12, 17), the legal issue in this case is not simply whether options traders may bring suit against a non-trading corporation. The court of appeals concluded—and the government agrees (Br. 7)—that Section 10(b) requires absolutely no connection between the defendant and the securities transaction engaged in by the plaintiff. Under the court's theory, a non-trading corporation may be held liable in damages to a trader of *any* security—whether issued by the corporation or not—as long as the trader can prove the other elements of the cause of action.

The potential expansion of liability under this rule is enormous. Assume, for example, that IBM issued a press release falsely stating that it had developed a new computer with superior capabilities. The misrepresentation would likely inflate the price of IBM securities, and it almost certainly would also depress the prices of securities issued by Apple, Wang, Data General, and IBM's other competitors. Under settled law, persons trading in IBM securities could recover damages from IBM based on the misstatement. Under the court of appeals' new legal test, however, persons trading in shares issued by these other corporations—and, presumably, persons trading in options to purchase or sell the shares of those corporations—also would be entitled to recover damages from IBM. The same result would seemingly obtain for

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[3] A standing rule is particularly necessary in cases involving public misrepresentations by a nontrading defendant because, in contrast to other sorts of claims under Section 10(b), there is no inherent limitation on the scope of the defendant's damages liability. In the insider trading context, for example, the defendant is liable only to contemporaneous traders in the same security. Where there are face-to-face misrepresentations by a nontrader with respect to a particular transaction, the defendant's liability would be limited to the participants in that transaction. It is only in the public misrepresentation context that a defendant is exposed to truly unlimited liability.

persons trading in securities issued by companies such as software suppliers, whose business is dependent upon compatibility with IBM products. And the same result presumably would follow for persons buying or selling securities (such as "baskets" (see Pet. 10)) that depend upon the price of IBM shares.

This has never been and should not be the law; yet it is precisely what the court of appeals' decision portends. The staggering damages liability that would result would be crippling to corporations as well as other potential defendants. Despite that, *neither the court of appeals nor the government has presented any legal basis for distinguishing between options and all other unrelated securities.* (The government seeks to fill this void by pointing out (Br. 15 n.19) the *factual* basis for conferring standing on options traders. But the economic link between a corporation's stock and another security is hardly unique to options, and in any event it supplies no *legal* distinction between options and other securities.) This Court should intervene to prevent such an enormous and unwarranted expansion of the scope of damages liability under this implied right of action. See *Associated General Contractors* v. *California State Council of Carpenters*, 459 U.S. 519, 534 (1983) (limiting class of potential antitrust plaintiffs on the basis of similar policy concerns).[4]

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[4] In view of the broad potential impact of the court of appeals' rule, the government's policy arguments (Br. 11-17) designed to show the reasonableness of permitting recovery by options traders are beside the point. The legal rule at issue here will have an impact far beyond the options context. In any event, these policy arguments are insubstantial. The government acknowledges (Br. 11) that there is "some force" to the argument that granting standing to options traders is unnecessary because in every case in which options traders could bring suit, an action could be brought by a corporation's present or former security holders. The government goes on to hypothesize (Br. 11-12), however, that options traders may have more of an incentive to sue in cases where the alleged misrepresentation produces only a small movement in the price of the corporation's own securities. But modern class actions provide the corporation's securities holders with an

3. The government implicitly acknowledges the dramatic change worked by the decision below, because it strains to emphasize other safeguards that it contends are sufficient to prevent the imposition of excessive damages liability under Section 10(b). Thus, the government suggests (Br. 14) that courts could—on a case-by-case basis—impose a cap on the total amount of damages liability that a defendant would have to bear.

This is a familiar tune. In *Blue Chip Stamps*, the Securities and Exchange Commission argued that the Court should not limit the class of private plaintiffs under Section 10(b) to persons who bought or sold securities, suggesting instead other limits upon the scope of Section 10(b). See 421 U.S. at 746-747 n.10. And in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), the Commission argued against imposition of a scienter re-

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incentive to sue even if the harm to each individual is quite small. (The government itself notes (Br. 12-13 & n.14) that the number of trades of the corporation's own securities is likely to be many times the trades of options; in virtually every case, therefore, the class of traders in corporate securities would certainly be large enough to provide sufficient incentive for a damages action.) There is thus no deterrence rationale for this expansion of liability.

Second, the government contends (Br. 12) that providing a damages remedy for options traders furthers Section 10(b)'s remedial purposes. But this Court in *Blue Chip Stamps* and *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), refused to construe Section 10(b) to ensure compensation for all persons misled by a defendant's misrepresentation, holding that other policy considerations outweighed that interest. The same is true here.

Finally, the government argues (Br. 14-16) that subjecting a corporation to liability at the hands of options traders comports with the common law rule. Again, the Court in *Blue Chip Stamps* squarely rejected the identical argument, refusing to define the private action implied under Section 10(b) by reference to the relevant common law tort concepts, because "the typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable." 421 U.S. at 744-745. Especially in view of the relaxed reliance standard embodied in the "fraud on the market" theory, a Section 10(b) claim simply cannot be analogized to a common law tort action.

quirement, putting forward alternative restrictions on the private right of action. 425 U.S. at 197-198 & n.18. This Court in each case rejected the government's invitation to broadly construe one element of the cause of action on the theory that any unwarranted liability could be eliminated by tinkering with the other elements of the claim. So here, the Court should impose rational limits on the scope of liability through a standing requirement and not rely on a hypothetical "fix" not responsive to the particular problem presented by this case- -unwarranted expansion of the class of potential plaintiffs.

The government also asserts (Br. 14) that the requirement that plaintiffs prove the other elements of Section 10(b) liability—scienter, materiality, and reliance—will restrict a corporate defendant's damages liability. But these assurances are cold comfort to companies that must bear the expense and inconvenience of defending such actions. The possibility that nonmeritorious claims might be weeded out at trial simply does not eliminate the burden imposed upon corporations by the existence of pending suits carrying the threat of huge monetary liability. The Court made these very points in rejecting a similar argument in *Blue Chip Stamps.* See 421 U.S. at 739-743.[5]

In sum, the language of the statute, relevant policy considerations, and this Court's precedents establish that Section 10(b) should not be construed to subject a corporation to monetary liability when it has neither traded in nor issued the securities in question.

B. Review By This Court Is Appropriate Now

The government concludes that a grant of certiorari is "not warranted at this time" (Br. 5), apparently be-

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[5] The government asserts (Br. 13-14 n.16) that *Blue Chip Stamps* is irrelevant, because the Court's decision rested solely on concerns about the unverifiable nature of non-traders' claims. In fact, the Court relied upon "two largely separate grounds" (421 U.S. at 740), one of which was the burden imposed by meritless "strike" suits (*id.* at 740-741, 742-743).

cause in its view there is no conflict among the courts of appeals, certain other issues regarding the scope of the cause of action remain unresolved, and the issue in this case is limited to suits by options traders (Br. 17-19). As we have discussed, the last point is simply wrong. The legal rule adopted by the Third Circuit expands the scope of a corporation's Section 10(b) damages liability well beyond options traders. For that reason alone, this Court should grant review.

The fact that the lower courts that allow options traders to recover damages have not yet fleshed out every rule governing the scope of that liability provides no reason for the Court to decline to address the threshold standing question presented in this case. The Court decided the substantially analogous standing issue in *Blue Chip Stamps* despite the fact that many rules governing the implied private action—such as the proper measure of damages and the proof necessary to show reliance—were then unresolved.

Finally, as we argued in the petition (at 17-22) and our reply brief (at 2-3), we disagree with the government's conclusion regarding the state of the law in the lower courts. First, *Laventhall* v. *General Dynamics Corp.*, 704 F.2d 407 (8th Cir. 1982), cert. denied, 464 U.S. 846 (1983), conflicts with the decision below. *Laventhall* plainly stands for the proposition that a corporation has no duty to speak truthfully to traders of securities that are strangers to the corporation. Second, contrary to the picture that the government tries to paint (Br. 17-18 n.24), there is substantial confusion among the district courts. Three courts have reached the same result as the court below, and three courts (including the district court in this case) have rejected that view. See *Starkman* v. *Warner Communications, Inc.*, 671 F. Supp. 297, 299, 301-307 (S.D.N.Y. 1987); *Bianco* v. *Texas Instruments, Inc.*, 627 F. Supp. 154, 161 (N.D. Ill. 1985).[6]

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[6] The government erroneously asserts (Br. 18 n.24) that *Starkman* involved only insider trading claims. However, the court's opinion

This confusion about a basic issue of securities law is intolerable. There has been an explosion in the trading of options and other derivative securities. See Pet. 7-11. The large number of reported decisions addressing the precise issue presented in the petition illustrates that options traders seek to recover damages under Section 10(b) with considerable frequency. (Now that this sort of claim has been endorsed by a court of appeals, it is likely to be asserted with increasing frequency. Indeed, future securities class actions will routinely include a claim on behalf of options traders, thereby complicating the litigation and increasing the settlement value of the case.) And, as we have discussed, the court of appeals' analysis cannot logically be limited to options. It subjects a corporation to liability to traders in *any* security.

This Court observed in *Blue Chip Stamps*, 421 U.S. at 741, that "to broadly expand the class of plaintiffs who may sue under Rule 10b-5 would appear to encourage" the use of the liberal provisions of the Federal Rules of Civil Procedure to extort large settlements from corporations wishing to avoid the inconvenience of discovery, even where the underlying claim is entirely frivolous. See also *id.* at 740. The practical burden of inflated litigation and settlement costs imposed by the erroneous decision below is real and ongoing and will be borne by defendants as long as that decision is permitted to stand. Because the rule adopted by the court of appeals also carries enormous potential for complex litigation and staggering monetary liability, this Court should resolve the issue now.

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makes clear that the case also concerned "material misrepresentations made by defendants to the public and * * * to the SEC." 671 F. Supp. at 299; see also *id.* at 305. Indeed, the court relied upon the decision of the district court in the present case and the decision in *Bianco.* See 671 F. Supp. at 306-307. Finally, the decision in a companion case (*id.* at 299) establishes beyond a doubt that the corporation itself was sued on a theory of nontrading liability. *In re Warner Communications Securities Litigation,* 618 F. Supp. 735, 739, 741-743 (S.D.N.Y. 1985).

Respectfully submitted.

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